

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Single Audits



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Interactive Self-study CPE
Companion to PPC's Guide to
Single Audits

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INTRODUCTION

Single Audits consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to Single Audits* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **July 31, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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Each course is divided into lessons. Each lesson addresses an aspect of single audits. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program or have adopted the standards and allow QAS CPE credit hours. Alternatively, you may visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours or have adopted the standards. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the "Overview" page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

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COMPANION TO PPC'S GUIDE TO SINGLE AUDITS

COURSE 1

COMPLIANCE AUDITING, SUBRECIPIENT CONSIDERATIONS, AND PROGRAM-SPECIFIC AUDITS (GSATG091)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course provides an introduction to compliance auditing, subrecipient considerations, and program-specific audits. The course discusses general and specific considerations that should be taken into account while performing financial audits of governmental and nonprofit entities and applies those considerations to disclosures and reporting requirements.
PUBLICATION/REVISION DATE:	June 2009
RECOMMENDED FOR:	Users of <i>PPC's Guide to Single Audits</i>
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of governmental auditing.
CPE CREDIT:	8 QAS Hours, 8 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours. Yellow Book CPE Credit: This course is designed to assist auditors in meeting the continuing education requirements included in GAO's <i>Government Auditing Standards</i> .
FIELD OF STUDY:	Auditing (Governmental)
EXPIRATION DATE:	Postmark by July 31, 2010
KNOWLEDGE LEVEL:	Basic

LEARNING OBJECTIVES:

Lesson 1—Compliance Auditing

Completion of this lesson will enable you to:

- Define the authority and coverage of the Yellow Book and recognize auditor responsibility with respect to error, fraud, illegal activities, and indication of abuse that arise during the course of the audit.
- Identify and apply compliance requirements and audit compliance.
- Define and identify questioned costs and report on compliance.

Lesson 2—Subrecipient Considerations

Completion of this lesson will enable you to:

- Identify and explain the difference between a subrecipient and a vendor.
- List the responsibilities of the pass-through entity, subrecipient, and auditor and discuss the Compliance Supplement's suggested audit procedures.
- Apply audit requirements for pass-through entities, subrecipients, and vendors and describe a limited scope engagement.

Lesson 3—Program-specific Audits

Completion of this lesson will enable you to:

- Identify the audit requirements for a program-specific audit.
- List and describe the reporting requirements for the entity and the auditor.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
GSATG091 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Compliance Auditing

INTRODUCTION

When performing financial audits of governmental and nonprofit entities, auditors must consider whether noncompliance with laws and regulations and the provisions of contracts and grant agreements could have a direct and material effect on the financial statements. If the entity receives federal awards and the audit is a single audit, that consideration is also at the major federal program level. The terms and concepts that are generally applicable to compliance auditing are relevant whether the audit is made in accordance with GAAS, *Government Auditing Standards*, OMB Circular A-133, or state or local agencies' audit requirements.

Auditing compliance at the financial statement level is required by GAAS and *Government Auditing Standards* (the Yellow Book). For a GAAS audit, SAS No. 74 (AU 801) requires the auditor to obtain an understanding of the possible financial statement effect of laws and regulations that have a direct and material effect on the financial statements, including fraud and illegal acts, and suggests procedures for that purpose. Both GAAS and the Yellow Book also require auditors to perform additional procedures if there is evidence of an illegal act that could have a material *indirect* effect on the financial statements. The Yellow Book extends auditors' consideration of laws and regulations to also cover violations of provisions of contracts and grant agreements.

Learning Objectives:

Completion of this lesson will enable you to:

- Define the authority and coverage of the Yellow Book and recognize auditor responsibility with respect to error, fraud, illegal activities, and indication of abuse that arise during the course of the audit.
- Identify and apply compliance requirements and audit compliance.
- Define and identify questioned costs and report on compliance.

Authoritative Literature

The following authoritative literature establishes requirements or provides suggestions relevant to compliance auditing.

- SAS No. 54 (AU 317), *Illegal Acts By Clients*.
- SAS No. 74 (AU 801), *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*.
- SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*.
- AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide).
- The Single Audit Act Amendments of 1996 (included in PPC's *Government Documents Library* at Gov. Doc. No. 1).
- United States Government Accountability Office (GAO), *Government Auditing Standards, July 2007 Revision*.
- OMB Circular A-21, *Cost Principles for Educational Institutions*, May 2004.
- OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, May 2004.
- OMB Circular A-102, *Grants and Cooperative Agreements with State and Local Governments*, revised October 1994.
- OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations*, revised November 1993, as amended

August 1997 and September 1999; and individual Circulars A-110 issued by federal agencies. (Each federal agency has issued its own Circular A-110 that reflects any statutorily required or other agency differences from the OMB Circular.)

- OMB Circular A-122, *Cost Principles for Non-Profit Organizations*, May 2004.
- OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Institutions*.
- *OMB Circular A-133 Compliance Supplement* (Compliance Supplement).
- OMB Common Rule for *Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments*, March 1988. (Each federal agency has published a "Federal Agency Implementation of the Common Rule" that indicates any statutorily required difference from the OMB Common Rule.)

OMB Grants Management Simplification

In an effort to simplify grants management, OMB has established Title 2 of the Code of Federal Regulations (CFR) as a single location for guidance on grants and agreements. Subtitle A of Title 2, *Government-wide Grants and Agreements*, contains OMB policy guidance to federal agencies on grants and agreements. Subtitle B, *Federal Agency Regulations for Grants and Agreements*, contains the federal agencies' regulatory implementation of OMB policy guidance. OMB moved the following Circulars into Title 2 CFR, Subtitle A, Chapter 2:

- Circular A-21, *Cost Principles for Educational Institutions* (2 CFR part 220).
- Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (2 CFR part 225).
- Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations* (2 CFR part 215).
- Circular A-122, *Cost Principles for Non-Profit Organizations*, (2 CFR part 230)

Although the circulars have been reissued in Title 2 of the CFR, the *OMB Circular A-133 Compliance Supplement* and this course to refer to them by either circular name and number or CFR part or section, (e.g., 2 CFR part 215 or 2 CFR section 215.27).

TYPES OF COMPLIANCE REQUIREMENTS

Section 500(d)(2) of OMB Circular A-133 directs the auditor to the *OMB Circular A-133 Compliance Supplement* (Compliance Supplement) to determine the compliance requirements for major program testing. The Compliance Supplement, which is discussed in more detail later in this lesson, has been revised annually since 1997.

Part 3 of the Compliance Supplement discusses the following 14 types of compliance requirements that should be considered in all audits (single and program-specific) conducted under OMB Circular A-133:

- 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.

These compliance requirements will be discussed later in this lesson.

While the above compliance requirements primarily affect the treatment of federal funds, the auditor must also be concerned with the client's compliance with all laws and regulations. This discussion follows.

RESPONSIBILITY FOR LAWS, REGULATIONS, AND OTHER MATTERS

Effect on the Financial Statements

In any audit made in accordance with GAAS, the auditor's responsibility concerning errors, fraud, and illegal acts relates to their possible effect on the financial statements. SAS Nos. 54 and 99 define this responsibility. SAS No. 99 (AU 316.01) 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.

SAS No. 54 at AU 317.05–.07 goes on to state that—

- .05 The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. . . . The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud as described in section 110, *Responsibilities and Functions of the Independent Auditor*.
- .06 Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects, and their financial statement effect is indirect. An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. . . . Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.
- .07 . . . If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial

statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, because of the characteristics of illegal acts explained above, an audit made in accordance with generally accepted auditing standards provides no assurance that illegal acts [that have indirect effects on the financial statements] will be detected. . . .

The Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to follow the GAO auditing standards for financial audits contained in the Yellow Book. Paragraphs 4.27–.28 of the Yellow Book point out that both GAAS and Yellow Book audits require auditors 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. In addition, auditors are required to design the audit to provide reasonable assurance of detecting misstatements resulting from illegal acts that could have a direct and material effect on the financial statements. If specific information comes to the auditor's attention that provides evidence about a possible illegal act that could have a material *indirect* effect on the financial statements, the auditor should apply additional procedures intended to determine if an illegal act has occurred. If an illegal act has or is likely to have occurred, the auditor should determine the effect on the financial statements and the implications for other aspects of the audit. (The Yellow Book does, however, contain reporting requirements related to compliance and abuse that go beyond GAAS.)

The Yellow Book, Paragraphs 4.10–.11, extends the auditor's consideration of laws and regulations to include compliance with provisions of contracts and agreements as follows:

Auditors should design the audit to provide reasonable assurance of detecting misstatements that result from violations of *provisions of contracts or grant agreements* and could have a *direct and material effect* on the determination of financial statement amounts or other financial data significant to the audit objectives.

If specific information comes to the auditors' attention that provides evidence concerning the existence of possible violations of provisions of contracts or grant agreements that could have a *material indirect effect* on the financial statements, the auditors should apply audit procedures specifically directed to ascertaining whether such violations have occurred. When the auditors conclude that a violation of provisions of contracts or grant agreements has or is likely to have occurred, they should determine the effect on the financial statements as well as the implications for other aspects of the audit. [Emphasis added.]

This means that in Yellow Book engagements, auditors have the same responsibilities for detecting material misstatements arising from violations of provisions of contracts or grant agreements as they do for detecting those arising from fraud and illegal acts. While the Yellow Book considers that to be an additional responsibility beyond GAAS, Paragraph 2.32 of the GAS/A-133 AICPA Audit Guide indicates that compliance with provisions of contracts and agreements is implicit in GAAS audits, though not specifically stated in SAS No. 54. Exhibit 1-1 included later in this lesson includes a comparison of compliance testing requirements under GAAS, the Yellow Book, the Single Audit Act Amendments, and OMB Circular A-133.

The Yellow Book includes requirements defining abuse and the auditor's responsibility when information comes to his or her attention indicating that abuse may have occurred. Abuse is a Yellow Book concept and would be reported in the Yellow Book report on internal control and compliance or in the OMB Circular A-133 report on compliance and internal control over compliance. Abuse is discussed later in this lesson.

Effect on the Major Program

The Single Audit Act Amendments of 1996 and OMB Circular A-133 go beyond GAAS and the Yellow Book in requiring the auditor to test compliance with laws and regulations that could have a material effect on each major federal award program. Sections 500(d) and 505(c) of OMB Circular A-133 require the auditor to determine and report whether the entity has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on *each* major program. GAAS and the Yellow Book require only that the auditor test compliance with laws and regulations that could have a direct and material effect on the *financial statements*. The Yellow Book, at Paragraph 4.10, also extends this requirement to other financial data significant to the audit objectives. Footnote 21 to Paragraph 2.32 of the GAS/A-133 AICPA Audit Guide notes that "other financial

data significant to the audit objectives relates to auditing procedures on financial data outside of the basic financial statements.” This includes required supplementary information (RSI), supplementary information other than RSI, and other types of financial audits such as single audits.

It is generally recognized that entities receiving federal awards have potentially more “direct and material effect” laws and regulations than entities not receiving such assistance. In governmental and nonprofit audits, there is often an expectation that the auditor will test more than just direct-effect laws and regulations; therefore, it is important for the engagement letter to clearly spell out the auditor’s responsibility for testing compliance. *Material effect* means that noncompliance with certain laws and regulations could affect the allowability or eligibility of recipients, of material amounts for federal program expenditures. Thus, the auditor should perform enough testing of major programs to provide a sufficient basis for expressing an opinion on compliance related to each major program.

Abuse

The Yellow Book contains an additional fieldwork standard that requires auditors to perform additional procedures if they become aware of abuse that could be quantitatively or qualitatively material to the financial statements. Yellow Book requirements relating to abuse have been controversial since they were first proposed. The following paragraphs discuss the Yellow Book requirements and related guidance in the GAS/A-133 AICPA Audit Guide.

Definition of Abuse. Paragraph 4.12 of the Yellow Book notes that abuse may not involve fraud, illegal acts, or violations of provisions of contracts or grant agreements. It states—

Abuse 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. Abuse does not necessarily involve fraud, violations of laws, regulations, or provisions of a contract or grant agreement.

Based on the Yellow Book’s definition of abuse, what constitutes abuse or potential abuse is not clear and will be open to interpretation. However, in Appendix I, Paragraph A.06, the Yellow Book provides the following examples of actions that may represent abuse, depending on the relevant facts and circumstances:

- a. Creating unneeded overtime.
- b. Requesting staff to perform personal errands or work tasks for a supervisor or manager.
- c. Misusing the official’s position for personal gain (including actions that could be perceived by an objective third party with knowledge of the relevant information as improperly benefiting an official’s personal financial interests or those of an immediate or close family member; a general partner, an organization for which the official serves as an officer, director, trustee, or employee; or an organization with which the official is negotiating concerning future employment).
- d. Making travel choices that are contrary to existing travel policies or are unnecessarily extravagant or expensive.
- e. Making procurement or vendor selections that are contrary to existing policies or are unnecessarily extravagant or expensive.

Auditor’s Responsibilities Relating to Abuse. Paragraph 4.13 of the Yellow Book provides the following fieldwork standard:

If during the course of the audit, auditors become aware of abuse that could be quantitatively or qualitatively material to the financial statements, auditors should apply audit procedures specifically directed to ascertain the potential effect on the financial statements or other financial data significant to the audit objectives. After performing additional work, auditors may discover

that the abuse represents potential fraud or illegal acts. Because the determination of abuse is subjective, auditors are not required to provide reasonable assurance of detecting abuse.

The GAS/A-133 AICPA Audit Guide, at Paragraph 3.35, provides the following guidance to auditors on their responsibilities relating to abuse:

- If the auditors conclude that a situation or transaction indicates that abuse may have occurred, auditors should evaluate whether the possible abuse could materially affect financial statement amounts or other financial data.
- If possible abuse could materially affect the financial statement amounts or other financial data, the auditors should extend audit procedures (such as extending sample sizes by selectively choosing additional testing items), as necessary.
- Auditors should consider both quantitative and qualitative factors in making judgments regarding the materiality of possible abuse and whether they need to extend the audit procedures. Qualitative factors may include whether the abuse is the result of an internal control deficiency, involves collusion or concealment, or is an isolated event.

Auditors do not have a responsibility to detect abuse under either GAAS or *Government Auditing Standards*. However, the Yellow Book establishes a presumptively mandatory requirement to perform certain additional procedures if information comes to their attention indicating that abuse may have occurred.

In situations where an auditor becomes aware of a situation or transaction that might constitute abuse, Paragraph 3.35 of the GAS/A-133 AICPA Audit Guide notes that the auditor should perform procedures to determine whether it is indicative of abuse. This may include making inquiries of auditee officials about the nature of and reasons for the situation or transaction. In addition, such procedures should involve evaluating whether the situation or transaction meets the definition of abuse. That includes determining whether the potential abuse involves fraud, illegal acts, or violations of provisions of contracts or grant agreements because the Yellow Book definition of abuse indicates abuse does not necessarily involve those conditions and it has different reporting standards for abuse.

When dealing with federal programs, auditors should not confuse abuse with instances of noncompliance. Footnote 15 to Paragraph 3.35 of the GAS/A-133 AICPA Audit Guide states "situations or transactions involving federal awards that might otherwise appear to constitute abuse instead generally are instances of noncompliance." According to Paragraph 3.35 of the GAS/A-133 AICPA Audit Guide, the procedures performed when evaluating potential abuse should also include evaluating whether the situation or transaction involves behavior that meets the part of the Yellow Book definition of abuse (i.e., 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). That determination is subjective and the auditor judgment is a factor.

The Yellow Book requires auditors to perform additional audit procedures if they become aware of abuse that could be quantitatively or qualitatively material to the financial statements. The following list of examples of qualitative factors that the auditor may consider relevant to the evaluation of whether a situation or transaction that constitutes abuse is material to the financial statements is derived from Paragraph 3.35 of the GAS/A-133 AICPA Audit Guide:

- 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.

Paragraph 5.10 of the Yellow Book requires auditors to report, as applicable to the objectives of the audit, abuse that could have a material effect on the financial statements. Paragraph 5.15 further states that auditors should include relevant information in their audit report about abuse when they conclude, based on sufficient, appropriate evidence, that abuse that is either quantitatively or qualitatively material occurred or is likely to have occurred.

Material Abuse Relating to the Financial Statements or Other Financial Data. The auditor should report abuse findings relating to financial statement audits in the Yellow Book report on internal control over financial reporting and on compliance and other matters. Paragraph 4.31 of the GAS/A-133 AICPA Audit Guide recommends that findings of abuse should be presented in or referred to in the compliance and other matters section of the report unless the primary nature of the finding is a significant deficiency in internal control. If the finding of abuse is a significant deficiency in internal control, the GSA/A-133 AICPA Audit Guide recommends that it be presented in the internal control section. If the finding of abuse relates to both internal control over financial reporting and to compliance, Paragraph 4.30 of the GAS/A-133 AICPA Audit Guide notes that the finding is generally reported in both sections (internal control over financial reporting and compliance and other matters). The reporting may be summarized in one section and referenced to detailed reporting in the other section.

Abuse Relating to Federal Awards. The Yellow Book fieldwork standard that requires auditors to apply additional procedures if they become aware of abuse that could be quantitatively or qualitatively material applies to all aspects of a single audit engagement, including the compliance audit portion. Thus, if the auditor becomes aware of a situation or transaction relating to major program testing that could constitute material abuse, the auditor should extend procedures to determine the potential effect on the financial statements or on the major program.

Auditors should not confuse abuse with instances of noncompliance. Paragraph 10.45 of the GAS/A-133 AICPA Audit Guide states:

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.

Although most findings relating to federal awards will be instances of noncompliance, there could be isolated situations or transactions that could constitute abuse. Paragraph 12.36 of the GAS/A-133 AICPA Audit Guide provides the following guidance about reporting findings of abuse relating to federal awards.

- *Abuse relating to federal awards that is material to the financial statement amounts*—report the finding in the financial statement section of the schedule of findings and questioned costs and refer to the finding from the Yellow Book report.
- *Abuse relating to federal awards that is material to a major program*—report 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 on compliance and internal control.
- *Abuse relating to both the financial statements and the federal awards*—report the finding in both sections (i.e., financial statement and federal awards) of the schedule, with the reporting in one section in summary form and a reference to a detailed reporting in the other section.

Paragraph 12.36 of the GAS/A-133 AICPA Audit Guide notes that in situations where 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, auditors "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."

Immaterial Abuse. If the auditor determines that an instance of abuse is not material to the financial statements or other financial data significant to the audit objectives, he or she also should consider whether the abuse is inconsequential. Generally, the Yellow Book requires the auditor to evaluate findings for the purpose of communication based on their effect on the financial statements or other financial data significant to the audit objectives. However, for single audits, the auditor should evaluate findings involving federal awards for the purpose of the communication based only on their consequence to the financial statements. Using this criteria, if the abuse is deemed to be less than material but more than inconsequential, the Yellow Book (Paragraph 5.16) requires the instance of immaterial abuse to be communicated in writing to officials of the audited entity. However, if the abuse is deemed to be inconsequential, the Yellow Book directs the auditor to use his or her professional judgment to determine whether and how to communicate to the auditee. Auditors should document such communications. This Yellow Book requirement relating to the consideration of how to report inconsequential abuse is the same as the consideration that should be given to deficiencies in internal control, fraud, illegal acts, and violations of provisions of contracts or grant agreements that are inconsequential. Paragraph 3.36 of the GAS/A-133 AICPA Audit Guide also addresses the consideration of whether abuse is inconsequential.

Other Considerations. As indicated in Paragraph 4.29 of the Yellow Book, auditors should exercise professional judgment in pursuing indications of possible abuse (as well as possible fraud, illegal acts, and violations of provisions of contracts or grant agreements) so that they do not interfere with potential investigations, legal proceedings, or both. When it appears that abuse has occurred, consulting with an attorney on the wording of the finding or report is recommended.

Reporting Fraud, Illegal Acts, Violations of Provisions of Contract or Grant Agreements, or Abuse

In Yellow Book engagements, auditors have the same responsibilities for detecting material misstatements arising from violations of provisions of contracts or grant agreements as they do for detecting those arising from fraud and illegal acts. However, the Yellow Book makes a distinction between the auditor's responsibilities for reporting fraud and illegal acts, and reporting abuse and noncompliance *other than* fraud and illegal acts. Paragraph 5.10 in the Yellow Book states that auditors should report "all instances of fraud and illegal acts unless inconsequential" and "violations of provisions of contracts and grant agreements and abuse that could have a material effect on the financial statements." Paragraph 5.15 in the Yellow Book makes it clear that material violations of the provisions of contracts and grant agreements should be reported as noncompliance. However, the Yellow Book prescribes additional responsibilities for reporting fraud, illegal acts, and abuse under certain circumstances.

The Yellow Book, at Paragraph 5.15, requires auditors to include relevant information in their audit report when they conclude, based on sufficient, appropriate evidence, that (a) fraud and illegal acts with a financial statement effect that is more than inconsequential, (b) violations of provisions of contracts or grant agreements with a material effect on the financial statements or other financial data significant to the audit, or (c) material abuse has occurred or is likely to have occurred. Footnote 68 to Paragraph 5.15 further states "Whether a particular act is, in fact, illegal may have to await final determination by a court of law or other adjudicative body. Disclosing matters that have led auditors to conclude that an illegal act is likely to have occurred is not a final determination of illegality."

With respect to what to report, the descriptions in Paragraph 5.10 of the Yellow Book for reporting are essentially the same as those included in GAAS except the Yellow Book requires auditors to report abuse. Paragraph 5.18 provides that in certain instances the auditor should report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse directly to parties other than the audited entity. Paragraphs 5.18 through 5.20 describe these instances as follows:

- The audited entity may be required by law or regulation to report certain fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse to specified external parties such as a federal inspector general or a state attorney general. In these instances, when the auditor has communicated his or her findings to the audited entity and the audited entity fails to make the required report to the external

party, then the auditors should communicate such an awareness to those charged with governance of the audited entity. If the audited entity does not make the required report within a reasonable period of time (the Yellow Book uses the phrase “as soon as practicable” after the auditors’ communication with those charged with governance), the auditor should report the findings directly to the external party specified in the law or regulation. (Paragraph 5.18a)

- When fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse is likely to have a material effect on the financial statements and involves awards received directly or indirectly from a government agency, auditors may have a duty to report directly if management fails to take remedial steps. Auditors should first report management’s failure to take timely and appropriate action to those charged with governance of the audited entity. Then, if the audited entity does not take timely and appropriate steps as soon as practicable, the auditors should report the entity’s failure to take timely and appropriate steps directly to the funding agency. (Paragraph 5.18b)
- The reporting described above is in addition to any legal requirements to report such information directly to parties outside the entity. Auditors should comply with these requirements even if they have resigned or been dismissed before completing the audit. (Paragraph 5.19)
- The auditor should obtain sufficient, appropriate evidence (such as confirmation from an outside source) that the findings have, in fact, been properly reported by the audited entity. If such evidence cannot be obtained, the auditor should report the findings as discussed above. (Paragraph 5.20)

It is strongly recommended that the auditor consult with an attorney on the wording of the report on fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse or possible acts noted. Fraud, illegal acts, and violations of provisions of contracts or grant agreements should also be reported as noncompliance in the appropriate reports required by OMB Circular A-133.

Presentation of Findings. The Yellow Book, at Paragraph 5.22, requires auditors to report their findings in perspective by describing the extent of their work and the nature and extent of the matters being reported. When applicable, auditors should relate the findings to the population or the number of cases identified and quantify the results using dollar values or other measures. Presentation of the findings should include (a) the criteria against which performance is measured, (b) the condition that exists, (c) the cause of or reason for the condition, and (d) the effect or potential effect of the condition.

The Yellow Book explains that the elements (i.e., the criteria, condition, cause, and effect or potential effect) needed for a finding depend entirely on the objectives of the audit. Paragraph 5.21 of the Yellow Book requires auditors to develop the elements of the findings to the extent necessary to achieve the objectives. It further explains that when audit findings are clearly developed, they “assist management or oversight officials of the audited entity in understanding the need for taking corrective action.” Sufficiently developed elements may provide recommendations for corrective actions.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. What is the Yellow Book?
 - a. A book of audit programs for government entities.
 - b. A list of federal laws applicable to grant awards.
 - c. A list of the required procedures to follow when reporting abuse during the course of an audit.
 - d. Government Auditing Standards from the General Accountability Office.
2. SAS No. 54 and 99 define the auditor's responsibility with respect to errors, fraud, and illegal acts. What is that responsibility?
 - a. Responsible to obtain reasonable assurance that the statements are free of material misstatement.
 - b. Responsible to obtain reasonable assurance that no violations of any equal employment laws and regulations were violated.
 - c. Responsible to provide assurance that illegal acts will be detected during the course of the audit.
3. Which statement below is correct concerning a single audit conducted in accordance with the Single Audit Act and OMB A-133?
 - a. The Yellow Book and GAAS are the final authoritative guidance for the auditor.
 - b. Compliance with regulations and laws must be tested for each major federal award program.
 - c. The guidance applies to both state and federal grants.
 - d. The guidance extends to auditing procedures on financial data outside of the basic financial statements.
4. With respect to abuse, the Yellow Book—
 - a. requires that laws must be broken in order to be classified as abuse.
 - b. interprets contracts and grant agreements in a uniform way.
 - c. details auditor responsibilities for reporting abuse.
5. According to the Yellow Book, what is required of the auditor when indicators of abuse arise?
 - a. Auditor should turn the issue over to legal specialists to confirm whether in fact abuse has occurred.
 - b. Auditor should extend audit procedures to determine whether in fact abuse occurred and the extent of abuse.
 - c. Auditor should provide reasonable assurance of detecting abuse by increasing audit procedures.
 - d. Regardless of materiality, auditors need to investigate indicators of abuse.

6. The Yellow Book requires auditors to report—
 - a. indicators of abuse.
 - b. significant abuse that has occurred or is likely to have occurred.
 - c. immaterial abuse if inconsequential.
 - d. only indicators of fraud.
7. According to the Yellow Book, when must auditors include in their audit reports relevant information concerning fraud and illegal acts?
 - a. When they conclude that any form of abuse has occurred or is likely to have occurred.
 - b. When they conclude that violations of contract provisions have an effect on the financial statements.
 - c. When they conclude the fraud and illegal acts had a financial statement effect that is more than inconsequential.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. What is the Yellow Book? **(Page 3)**

- a. A book of audit programs for government entities. [This answer is incorrect. Procedures for the purpose of understanding any fraud or illegal acts that might have a direct and material effect on the financial statements are suggested in SAS No. 74, not in the Yellow Book.]
- b. A list of federal laws applicable to grant awards. [This answer is incorrect. Auditors are to consider the laws and regulations to cover violations of provisions of grant agreements and this is covered in the Yellow Book, but not the list of federal laws applicable to grant awards.]
- c. A list of the required procedures to follow when reporting abuse during the course of an audit. [This answer is incorrect. There is a requirement for auditors to perform additional procedures if there is evidence of an illegal act that might produce a material indirect effect on the financial statements, but the Yellow Book does not list out procedures about abuse reporting.]
- d. **Government Auditing Standards from the General Accountability Office. [This answer is correct. The Yellow Book is published by the General Accountability Office (GAO) and contains government auditing standards. The Yellow Book contains the requirement to audit compliance at the financial statement level.]**

2. SAS No. 54 and 99 define the auditor's responsibility with respect to errors, fraud, and illegal acts. What is that responsibility? **(Page 5)**

- a. **Responsible to obtain reasonable assurance that the statements are free of material misstatement. [This answer is correct. GAAS specifically defines the auditor's responsibility as extending to any material misstatement, whether caused by error or fraud.]**
- b. Responsible to obtain reasonable assurance that no violations of any equal employment laws and regulations were violated. [This answer is incorrect. SAS provides recognition of the fact that auditors ordinarily will not have sufficient basis for recognizing possible violation of such laws and regulations unless informed by the client, or other evidence surfaces, which in that case, more procedures should be performed.]
- c. Responsible to provide assurance that illegal acts will be detected during the course of the audit. [This answer is incorrect. If an auditor suspects illegal acts have occurred, the auditor is required to apply audit procedures directly to the suspected area, however, an audit made in accordance with GAAS provides *no* assurance that illegal acts will be detected.]

3. Which statement below is correct concerning a single audit conducted in accordance with the Single Audit Act and OMB A-133? **(Page 6)**

- a. The Yellow Book and GAAS are the final authoritative guidance for the auditor. [This answer is incorrect. The Single Audit Act and OMB Circular A-133 extend requirements beyond the Yellow Book and GAAS.]
- b. **Compliance with regulations and laws must be tested for each major federal award program. [This answer is correct. The auditor is required to determine and report compliance of the entity as well as the provisions of contracts or grant agreements that may have a direct and material effect on each major program as opposed to GAAS and the Yellow Book that require only compliance testing for that which could have direct and material effect on the *financial statements*.]**
- c. The guidance applies to both state and federal grants. [This answer is incorrect. The Single Audit Act and OMB A-133 apply to only federal grants.]

- d. The guidance extends to auditing procedures on financial data outside of the basic financial statements. [This answer is incorrect. The Yellow Book extends the requirements to other financial data significant to the audit objectives including required supplementary information and other types of audits like Single Audits.]

4. With respect to abuse, the Yellow Book— **(Page 7)**

- a. requires that laws must be broken in order to be classified as abuse. [This answer is incorrect. The breaking of a law is not a requirement of abuse as defined in the Yellow Book.]
- b. interprets contracts and grant agreements in a uniform way. [This answer is incorrect. What constitutes abuse as defined by the Yellow Book is open to interpretation and auditor judgment.]
- c. details auditor responsibilities for reporting abuse. [This answer is correct. The Yellow Book provides guidance for reporting abuse.]**

5. According to the Yellow Book, what is required of the auditor when indicators of abuse arise? **(Page 8)**

- a. Auditor should turn the issue over to legal specialists to confirm whether in fact abuse has occurred. [This answer is incorrect. The auditor should not turn the matter over to authorities. Rather there are other steps that he or she is required to take.]
- b. Auditor should extend audit procedures to determine whether in fact abuse occurred and the extent of abuse. [This answer is correct. Audit procedures should be extended to confirm the existence of abuse (such as extending sample sizes by selectively choosing additional testing items).]**
- c. Auditor should provide reasonable assurance of detecting abuse by increasing audit procedures. [This answer is incorrect. The Yellow Book specifically states in paragraph 4.13 that because the determination of abuse is subjective, auditors are not required to provide reasonable assurance of detecting abuse.]
- d. Regardless of materiality, auditors need to investigate indicators of abuse. [This answer is incorrect. The first step auditors should take is to consider whether the possible abuse might have a material effect on the financial data. If financial statements could be materially affected, further steps need to follow.]

6. The Yellow Book requires auditors to report— **(Page 9)**

- a. indicators of abuse. [This answer is incorrect. Just because indicators are detected, does not mean abuse has occurred.]
- b. significant abuse that has occurred or is likely to have occurred. [This answer is correct. The Yellow Book requires auditors to report significant abuse that has occurred or is likely to have occurred.]**
- c. immaterial abuse if inconsequential. [This answer is incorrect. If an auditor determines that an instance of abuse is not material for the financial statements or other financial data significant to the audit objectives, then it should also be determined whether the abuse is inconsequential. If it is clearly not inconsequential, then it should be reported in the management letter.]
- d. only indicators of fraud. [This answer is incorrect. Indicators of fraud are not the only items that auditors are required to report.]

7. According to the Yellow Book, when must auditors include in their audit reports relevant information concerning fraud and illegal acts? **(Page 10)**
- a. When they conclude that any form of abuse has occurred or is likely to have occurred. [This answer is incorrect. The conclusion must be that the abuse was material.]
 - b. When they conclude that violations of contract provisions have an effect on the financial statements. [This answer is incorrect. The conclusion must be that the effect was material.]
 - c. **When they conclude the fraud and illegal acts had a financial statement effect that is more than inconsequential. [This answer is correct. Paragraph 5.15 of the Yellow Book has this as a requirement.]**

IDENTIFYING COMPLIANCE REQUIREMENTS

How are the significant laws and regulations applicable to particular federal awards identified? Sources of information include statutes and the Code of Federal Regulations, the grant agreement or policy manuals related to the particular program, and inquiries of the client's management, the cognizant or oversight agency for audit, or the federal agency that administers the program. Also, the *Catalog of Federal Domestic Assistance* lists most federal award programs and cites the laws and regulations applicable to each program and the names of the program staff who serve as "reference individuals" for the program. However, this can be a very time-consuming process, and even after the laws and regulations relevant to a particular program are identified, the auditor must still make a judgment about which ones are significant. To assist the auditor in identifying appropriate compliance requirements, the OMB issued the Compliance Supplement, which is discussed in the following paragraphs.

OMB Circular A-133 Compliance Supplement

Issuance. In June 1997, the OMB issued a "provisional" copy of the 1997 *OMB Circular A-133 Compliance Supplement*. The Compliance Supplement, which was issued in response to the changes contained in the Single Audit Act Amendments of 1996 and the 1997 OMB Circular A-133, superseded the previous separate compliance supplements developed for governmental units and nonprofit entities. The Compliance Supplement addresses the compliance requirements for both governmental units and nonprofit organizations. The June 1997 Compliance Supplement was considered provisional because it was not issued as a final document by the OMB. However, the OMB indicated it should be used by auditors pending the issuance of a revised Supplement.

Updates. The Compliance Supplement has been revised annually since 1997. The March 2008 Compliance Supplement supersedes the 2008 Compliance Supplement and is effective for audits of fiscal years beginning after June 30, 2008. The 2009 Compliance Supplement has been significantly revised to add new programs, change existing programs, clarify auditing guidance, and make various technical corrections. The 2009 Compliance Supplement also contains initial information—primarily in Appendix VII—about the effect of the American Recovery and Reinvestment Act of 2009 on OMB Circular A-133 audits. Appendix V of the 2009 Compliance Supplement includes a summary of differences, by part, between the March 2008 Compliance Supplement and the 2009 Compliance Supplement. The funding federal agencies are responsible for annually providing OMB updates to the Compliance Supplement.

Because the Compliance Supplement is updated annually, it is important to use the correct update for the year being audited. The 2009 Compliance Supplement should be used for audits of fiscal years ending after June 30, 2008. For audits of previous years, auditors should use the version of the Supplement that was in effect at that time. The OMB Web site (www.whitehouse.gov/omb/grants_circulars/) includes not only the 2009 Compliance Supplement, but also previous years' versions.

American Recovery and Reinvestment Act of 2009 Considerations. Appendix VII cautions auditors that due to the limited time between enactment of the American Recovery and Reinvestment Act of 2009 (Recovery Act) and issuance of the 2009 Compliance Supplement, the Compliance Supplement was not updated for revisions needed because of the Recovery Act. The OMB will periodically issue addenda to the Compliance Supplement to address requirements relating to audits of Recovery Act awards, including unique compliance requirements and changes in clusters. The Appendix specifically mentions that the OMB expects to provide additional guidance on the Reporting compliance requirement. The first statutory reporting deadline (applicable only to Recovery Act awards) will be for the quarter ending September 30, 2009, and is due to the Federal awarding agency by October 10, 2009. OMB plans to make detailed reporting instructions available at www.federalreporting.gov no less than 45 days before the October 10, 2009, reporting deadline. Appendix VII also indicates changes to clusters for that fiscal period will be applicable to audits of the fiscal period ending June 30, 2009. Information on changes to clusters will be posted on the OMB management website, www.whitehouse.gov/omb/management, no later than June 30, 2009. The OMB plans to release additional cluster changes at the end of each month.

Purpose. The purpose of the Compliance Supplement is to assist auditors in planning and performing audits in accordance with the Single Audit Act Amendments of 1996 and OMB Circular A-133. In doing so, the Compliance Supplement provides an important source of information for auditors to understand a program's objectives,

procedures, and compliance requirements and to assist the auditor in determining appropriate audit objectives and audit procedures for federal programs. The 2009 Compliance Supplement states that:

Auditors shall consider this Supplement and the referenced laws, regulations, and OMB Circulars . . . in determining the compliance requirements that could have a direct and material effect on the programs included herein. That is, use of the Supplement is mandatory.

References to the Code of Federal Regulations (CFR) and other source information are provided to assist the auditor in locating the underlying authoritative documents.

Organization. The 2009 Compliance Supplement is comprised of seven parts and nine appendixes as follows:

Part 1	<i>Background, Purpose, and Applicability.</i> Addresses background information, transitional issues, and the format of the Compliance Supplement. It also summarizes the purpose of each part of the Compliance Supplement.
Part 2	<i>Matrix of Compliance Requirements.</i> Lists by CFDA number the programs that are included in the Compliance Supplement and indicates which compliance requirements should be considered for each program.
Part 3	<i>Compliance Requirements.</i> Lists and describes the 14 types of compliance requirements and, except for "Special Tests and Provisions," the related audit objectives applicable to federal programs with the exception of program-specific audits performed in accordance with a federal agency's program-specific audit guide. It also provides the auditor with suggested audit procedures to address the audit objectives.
Part 4	<i>Agency Program Requirements.</i> Discusses program objectives, program procedures, and compliance requirements by CFDA number, that are specific to the program.
Part 5	<i>Clusters of Programs.</i> Identifies programs that may be treated as a single program under OMB Circular A-133 and provides compliance requirements, audit objectives, and suggested audit procedures for the research and development and student financial aid clusters.
Part 6	<i>Internal Control.</i> Presents characteristics of internal control that may reasonably ensure compliance with the types of compliance requirements.
Part 7	<i>Guidance for Auditing Programs Not Included in This Compliance Supplement.</i> Provides guidance for identifying the compliance requirements and designing compliance tests for programs not included in the Compliance Supplement.
Appendix I	Federal Programs Excluded from the A-102 Common Rule.
Appendix II	Federal Agency Codification of Certain Governmentwide Grants Requirements.
Appendix III	Federal Agency Contacts for A-133 Audits.
Appendix IV	Internal Reference Tables.
Appendix V	List of Changes for the 2009 Compliance Supplement.
Appendix VI	Disaster Waivers and Special Provisions Affecting Single Audits
Appendix VII	Other OMB Circular A-133 Advisories.
Appendix VIII	SAS 70 Examinations of EBT Service Organizations.
Appendix IX	Compliance Supplement Core Team.

Types of Compliance Requirements. Part 3 of the Compliance Supplement presents 14 types of compliance requirements that often have a direct and material effect on many federal awards programs. The following is a summary of the description of each of the 14 types of compliance requirements:

- a. *Activities Allowed or Unallowed.* Requires that the types of goods or services purchased with federal awards be specified as allowable under program requirements.
- b. *Allowable Costs/Cost Principles.* Requires that both direct and indirect costs meet certain criteria to be eligible for federal reimbursement. In addition, costs must conform to limitations or exclusions set forth in applicable cost principles, or with limitations or requirements specified in the program regulations or agreement. Allowable cost principles for state and local governments are set forth in OMB Circular A-87 (2 CFR part 225). Cost principles for educational institutions and other nonprofit organizations are set forth in OMB Circulars A-21 (2 CFR part 220) and A-122 (2 CFR part 230), respectively. Exhibit 1 is presented to assist the auditor in quickly assessing the differences in allowable costs between the three cost circulars and in identifying the allowability of costs.
- c. *Cash Management.* Requires recipients to have procedures to reduce the time between receipt and use of federal funds for funds that are advanced. When funds are provided on a cost reimbursement basis, program costs must be paid for with the entity's funds before reimbursement is requested.
- d. *Davis-Bacon Act.* Requires that, when required by federal grant program legislation, wage rates paid to laborers on federally financed construction projects at least equal locally established rates.
- e. *Eligibility.* Requires that individuals, groups, or subrecipients to whom organizations may provide financial awards or services meet specified criteria.
- f. *Equipment and Real Property Management.* Requires organizations to maintain an equipment and property management system for its federal award programs and related activities that is adequate to meet the requirements of OMB Circular A-110, Section 34, and the A-102 Common Rule, Section 32.
- g. *Matching, Level of Effort, Earmarking.* Requires that an organization receiving federal awards contribute its own resources to programs funded in some specified ratio to resources provided by the funding source.
- h. *Period of Availability of Federal Funds.* Where a funding period is specified, requires that a recipient charge to the grant only allowable costs resulting from obligations incurred during the funding period and any pre-award costs or carryover balances authorized by the federal awarding agency and the applicable cost circular.
- i. *Procurement and Suspension and Debarment.* Requires that—
 - (1) Recipients establish procedures for the procurement of supplies and other expendable property, equipment, real property and other services with federal funds to ensure that such materials and services are obtained in an effective manner and in compliance with the provisions of applicable federal statutes and executive orders.
 - (2) Contracts not be made to parties listed on the General Services Administration's *Excluded Parties List System* (EPLS), in accordance with E.O.s 12549 and 12689, "Debarment and Suspension." The EPLS, which is maintained by the General Services Administration on the Internet at <http://epls.arnet.gov>, replaces the GSA's "List of Parties Excluded from Federal Procurement or Nonprocurement Programs." This list contains the names of parties debarred, suspended, or otherwise excluded by agencies, and contractors declared ineligible under statutory or regulatory authority other than E.O. 12549.
- j. *Program Income.* Requires program income earned during the project period be retained by the recipient and be used in accordance with federal awarding agency regulations or the terms and conditions of the award.

- k. *Real Property Acquisition and Relocation Assistance*. Requires that certain procedures be followed when federal awards are used to acquire property or when relocations are involved.
- l. *Reporting*. Requires that specific reports be filed and additional requirements that apply to those reports. Note: Part 3 of the 2009 Compliance Supplement discusses the transition to a new government-wide Federal Financial Report (SF-425/425A), which will supersede the Financial Status Report/Federal Cash Transactions Report (SF-269 or 269A)/SF-272). Recipients will submit either the new government-wide report or the previous report depending on the report due date and federal awarding agency or program requirements.
- m. *Subrecipient Monitoring*. Requires recipients to have an adequate subrecipient monitoring and follow-up system covering entities to which it has passed through funds.
- n. *Special Tests and Provisions*. Includes other provisions for which federal agencies have determined that noncompliance could have a direct and material effect on the program, such as the requirements for public hearings or deadlines for expending federal funds. These provisions are contained in Part 4 or Part 5 of the Compliance Supplement.

Determining Compliance Requirements and Which Requirements to Test. Using the matrix presented in Part 2 of the Compliance Supplement, the auditor should determine which of the 14 requirements apply to each major program included in the Compliance Supplement for an audit performed in accordance with OMB Circular A-133. A “Y” (yes) in the program’s row on the matrix indicates the applicable compliance requirement applies to that program. The auditor would then refer to Parts 3, 4, and 5 (for clusters) in planning and performing the tests of compliance.

Although the matrix may indicate that a compliance requirement applies to a program, it may not apply to a particular auditee because either the auditee does not have activity subject to that type of compliance requirement or the activity could not have a material effect on a major program. For example, although there may be a “Y” in the matrix indicating that the Real Property Acquisition/Relocation Assistance compliance requirement may apply to a particular program, it would not apply if the auditee did not acquire real property covered by the Uniform Relocation Assistance and Real Property Acquisition Policies Act. If the auditor concludes that the effect of not complying with the compliance requirement would not be material to the program, the requirement need not be tested. The 2009 Compliance Supplement states that the auditor should exercise professional judgment when making this determination. Thus, as stated in the 2009 Compliance Supplement:

In making a determination not to test a compliance requirement, the auditor must conclude that the requirement either does not apply to the particular non-Federal entity or that noncompliance with the requirement could not have a material effect on a major program.

Paragraph 10.16 of the GAS/A-133 AICPA Audit Guide contains similar guidance.

When determining which requirements marked “Y” need to be tested, auditors should assess each compliance requirement individually. They should consider both quantitative and qualitative materiality when deciding whether an applicable compliance requirement is material to a major program. The GAS/A-133 AICPA Audit Guide, paragraph 10.16, further states:

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.

It is not sufficient to merely indicate a requirement is “N/A” or “Not direct and material.”

Each type of compliance requirement listed in Part 3 is accompanied by audit objectives and suggested audit procedures that may be used to test for compliance in an OMB Circular A-133 audit, except for program-specific audits performed in accordance with a federal agency’s program-specific audit guide. Part 4 or 5 contains additional information on the objectives, procedures, and compliance requirements that are unique to each program

included in the Compliance Supplement. Part 4 also provides subsection IV—Other Information when there is other useful information pertaining to the program that does not fit in sections I–III (program objectives, program procedures, and compliance requirements). The Compliance Supplement indicates, for example, that when a program allows funds to be transferred to another program, subsection IV will provide guidance on how those funds should be treated on the Schedule of Expenditures of Federal Awards and Type A program determinations.

When five of the types of compliance requirements (activities allowed or unallowed; eligibility; matching; level of effort; earmarking; reporting; and special tests and provisions) are applicable to a program included in the Compliance Supplement, Part 4 or 5 will always provide information specific to the program. However, Parts 4 and 5 do not include guidance for all types of compliance requirements that pertain to a program, so those Parts should be used in conjunction with Parts 2 and 3. Auditors can refer to Part 3 for a general description of the compliance requirement, audit objectives, and suggested audit procedures and with the exception of special tests and provisions to Part 4 or Part 5 (for clusters) for information about the specific program requirements. Since special tests and provisions are unique to the program, all audit objectives and suggested audit procedures for the program are included in Part 4 or 5. In addition, Part 6 (Internal Control) may be useful in assessing control risk and designing tests of internal control relating to each applicable compliance requirement.

Part 2 also indicates that a shaded compliance requirement (program *normally* does not have activity subject to this type of compliance requirement) can be applicable to the program if specific information comes to the auditor's attention that indicates the requirement could have a material effect on a major program. In that case, which is expected to be infrequent, the auditor would be expected to test the requirement.

The other nine types of compliance requirements generally are not specific to a program and therefore are usually not listed in Part 4. However, when one of these other nine types of compliance requirements has information specific to a program, this specific information will be provided with the program in Part 4. When a requirement is marked as "Not Applicable," it means that either there are no compliance requirements or the auditor is not required to test compliance.

The descriptions of the compliance requirements in Parts 3, 4, and 5 are generally a summary of the actual compliance requirements. Auditors should refer to the referenced citations (e.g., laws and regulations) for the complete compliance requirements. For research and development (R&D) and student financial aid (SFA), Part 5 is the equivalent of Part 4; therefore, the auditor will need to consider Parts 2, 3, and 5 in developing the audit program for these programs (program clusters).

Documenting Applicable Compliance Requirements. The auditor should document in the workpapers the types of compliance requirements that the matrix in Part 2 of the Compliance Supplement indicates are applicable to the major program. This may be accomplished by including a copy of the relevant page of the matrix in the workpapers, developing a matrix that reflects only the auditee's major programs, or preparing a memorandum. In addition, the auditor should document his or her consideration supporting the decision as to which compliance requirements could have a material effect on the program and therefore should be tested. Similar documentation is also necessary to support the auditor's consideration of the types of compliance requirements that apply to a major program that is not included in the Compliance Supplement.

Internal Reference Tables. Appendix IV, Internal Reference Tables, provides a listing of programs in Parts 4 and 5 that include subsection IV—Other Information, *or* that were identified as high-risk by OMB pursuant to Section 525(c)(2) of OMB Circular. The listing in Appendix IV allows auditors to quickly determine which programs have other information such as guidance on Type A and B program determination or presentation on the Schedule of Expenditures of Federal Awards. Appendix IV also includes a summary of programs designated as high-risk by OMB to ease identification of such programs. OMB has only designated the Medicaid Cluster (93.778) as high-risk.

Suggested Audit Procedures. The audit procedures for testing compliance included in the Compliance Supplement are only suggested and are not the only procedures an auditor may use, nor should they be considered a "safe harbor." The Compliance Supplement states:

The suggested audit procedures are, as the name implies, only suggested. Auditor judgment will be necessary to determine whether the suggested audit procedures are sufficient to achieve the stated audit objectives and whether alternative audit procedures are needed. Determining the

nature, timing, and extent of the audit procedures necessary to meet the audit objectives is the auditor's responsibility.

Questions regarding a requirement, including requests for information about changes in requirements, should be addressed to the granting or funding department or agency. Auditors are responsible for testing and reporting on compliance relative to major programs even if a major program is not included in the Compliance Supplement. Because the Compliance Supplement contains summary information, auditors may wish to refer to the specific statutes cited or to specific grant agreements or federal policy manuals to gain a more complete understanding of the laws and regulations. In addition, additional compliance requirements may be unique to the particular auditee.

The Compliance Supplement also includes generic audit objectives and suggested audit procedures to test internal control for each of the 14 types of compliance requirements. However, auditors should use professional judgment to determine the specific internal control testing procedures that should be performed.

To assist auditors in accurately determining appropriate compliance requirements, objectives, and audit procedures, PPC developed an Internet-based software product called *Single Audit Compliance Program Creator*. It creates a custom audit procedures checklist (compliance program) from the *OMB Circular A-133 Compliance Supplement*, tailored to specific federal programs and client characteristics. The *Single Audit Compliance Program Creator* is available by calling (800) 323-8724.

Possible Changes to and Additional Compliance Requirements

Safe Harbor Status. Some auditors have questioned whether, for programs listed in the Compliance Supplement, they need to be concerned with compliance requirements or audit procedures beyond those listed. According to Section 500(d)(3) of OMB Circular A-133, an audit of the compliance requirements contained in the Compliance Supplement will meet the requirements of OMB Circular A-133. The Compliance Supplement provides additional guidance to clarify the "safe harbor" status of the Supplement. Specifically, Part 1 of the Compliance Supplement states that due to the diversity of programs and administering entities, the suggested audit procedures are necessarily general in nature. Thus, auditors must use judgment in determining whether such procedures are sufficient to achieve the stated audit objectives, or whether additional or alternative audit procedures are necessary. OMB states that the Supplement is *not* a "safe harbor" for identifying the audit procedures that must be applied in a single audit. However, it clarifies that the Supplement *can* be considered a "safe harbor" for identification of compliance requirements to be tested for programs included in the supplement if the auditor *both*—

- performs reasonable procedures to ensure that the requirements in the Supplement are current and to determine whether there are any additional provisions of contract and grant agreements that should be covered by the audit.
- updates or augments the requirements contained in the Supplement as appropriate.

The Compliance Supplement defines reasonable procedures as inquiry of the entity's management and review of the contract and grant agreements for the major programs being tested.

Because the Compliance Supplement only provides "suggested" audit procedures, it cannot be used as a safe harbor for determining the specific audit procedures to apply in a particular situation. Auditor judgment is needed to determine whether the suggested procedures are sufficient or whether additional or alternative audit procedures should be applied. Thus, it is important to have a good understanding of your client's particular facts and circumstances, and its federal programs, to determine the correct procedures to apply.

American Recovery and Reinvestment Act of 2009 Considerations. Appendix VII cautions auditors that the 2009 Compliance Supplement was not updated for revisions needed due to the Recovery Act. Thus, compliance requirements for Recovery Act funds are not included in the Compliance Supplement. The OMB plans to periodically issue addenda to the Compliance Supplement to address requirements relating to audits of Recovery Act awards, including unique compliance requirements. The Appendix specifically mentions that the OMB expects to provide additional guidance on the Reporting compliance requirement.

Determining Current Compliance Requirements. If changes have occurred in the compliance requirements and those changes have not been reflected in the Compliance Supplement, the auditor should identify the revised

compliance requirements and modify the audit procedures accordingly. Although Section 400(c)(6) of the Circular indicates that federal awarding agencies are responsible for providing annual updates of the Compliance Supplement to OMB, Paragraph 10.18 of the GAS/A-133 AICPA Audit Guide states that “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.”

Potential sources of information about possible changes in program requirements or the Compliance Supplement include:

- Inquiry of client personnel; i.e., the finance director, internal auditors, legal counsel, or the compliance officer, or grant or contract administrators.
- Contact with the federal grantor agency or the cognizant or oversight agency for audit. (One of the responsibilities of the cognizant agency for audit is to provide technical audit advice and liaison to auditors. As previously mentioned, federal agencies are to provide annual update information for the Compliance Supplement to OMB.)
- Review of the *Catalog of Federal Domestic Assistance*, which gives citations to applicable laws and regulations for all federal award programs and the names of program staff who serve as reference individuals for each program. The CFDA listings are provided on the CFDA website at www.cfda.gov. The website is updated bi-weekly as new or updated program information is received from federal agencies.
- Review of contract or grant agreements to determine any additional requirements as well as whether specific requirements reflected in the Compliance Supplement have changed. Paragraph 10.18 of the GAS/A-133 AICPA Audit Guide indicates this would include any guidance (e.g., handbooks, operating procedures) or other correspondence issued by the awarding agency or pass-through entity. In addition, 2 CFR Part 176, Award Terms for Assistance Agreements that Include Funds Under the American Recovery and Reinvestment Act of 2009, Public Law 111–5, requires pass-through entities to separately identify to subrecipients the federal award number, CFDA number, and amount of Recovery Act funds. When Recovery Act funds are passed-through for an existing program, the incremental funds have to be separately identified.
- Inquiry of pass-through entities if the client is a subrecipient. [Section 400(d)(2) of OMB Circular A-133 requires pass-through entities to advise subrecipients of any federal laws, regulations, and the provisions of contract or grant agreements, as well as any supplemental requirements imposed by the pass-through entity.]
- Review of newsletters, etc., for example, *The CPA Letter* and the *Journal of Accountancy*, which are sent to all AICPA members, report activities related to the single audit, or *The PPC Nonprofit Update* or *The PPC Governmental Update* monthly newsletters.
- Review of single audit-related Internet sites.

American Recovery and Reinvestment Act of 2009 Considerations. Appendix VII indicates that the auditor should consider all programs with expenditures of Recovery Act funds to be “programs of higher risk” in accordance with OMB Circular A-133. Accordingly, it is more likely the auditor will determine these programs to be major programs using the criteria specified in OMB Circular A-133. However, because the 2009 Compliance Supplement was not updated for the Recovery Act, if the recipient expended Recovery Act funds, the auditor should do the following to identify material compliance requirements and determine appropriate audit procedures:

- a. Review award documents, including terms and conditions.
- b. Check the OMB Management website for addenda to the Compliance Supplement.
- c. Use the framework provided in Parts 3, 4, 5, and 7 of the Compliance Supplement.

Considering Additional Provisions of Contracts or Grant Agreements. Additional compliance requirements may be unique to the particular grant and/or auditee. Thus, the Compliance Supplement and Paragraph 10.19 of the GAS/A-133 AICPA Audit Guide state that auditors should consider whether there are any provisions of contracts

or grant agreements that are unique to a particular entity. Examples provided in the GAS/A-133 AICPA Audit Guide include (a) a grant agreement that specifies the matching percentage, and (b) requirements that are not included in laws or regulations, but may be part of the audit resolution process relating to prior audit findings.

Federal Programs Not Included in the Compliance Supplement. When a federal program subject to compliance testing is not included in the Compliance Supplement, Section 500(d)(3) of OMB Circular A-133 requires the auditor to use the 14 types of compliance requirements as guidance for determining the compliance requirements to test and to determine the appropriate requirements based upon a review of the grant agreement and related laws. Part 7 of the Compliance Supplement provides detailed guidance on identifying the compliance requirements and designing compliance tests for programs not included in the Compliance Supplement. Since the Compliance Supplement can only include program information for a limited number of the over 1200 federal programs with assigned CFDA numbers, many auditors will be required to address this situation.

Nonfederal Award Programs

When financial awards are provided directly by a state or local government, the auditor should consider consulting with state and local government officials or other sources of information about the nature and scope of required testing. In addition to discussion with officials of the entity and reading agreements, the auditor should consider making inquiries of the audit staff of the agency providing the awards and, perhaps, the office of the state auditor. In some cases, information about compliance requirements may be available from a state society of CPAs. State or local governmental funds provided directly to a recipient should be segregated and reported separately from state or local pass-through of federal funds, since the federal pass-through funds are considered part of the federal awards received by the entity. If the auditor is engaged to test and report on compliance with state and local laws and regulations, SAS No. 74 provides guidance on the auditor's responsibilities in these circumstances. Some state or local grant agreements may require an engagement in accordance with SSAE No. 10 (AT 601, *Compliance Attestation*) related to compliance with laws and regulations or the effectiveness of the entity's internal control over compliance. *PPC's Guide to Nontraditional Engagements* provides guidance on engagements performed under the attestation standards.

RELATION OF COMPLIANCE TESTS TO INTERNAL CONTROLS

The Yellow Book and OMB Circular A-133 include requirements for reports on internal control. Government officials consider internal controls to be very important because audits and grantor agency reviews can provide only periodic monitoring of the use of grant funds. Internal control can provide continuous monitoring.

Grantor agency regulations are usually concerned with all of a governmental unit's or nonprofit organization's controls relating to the receipt, disbursement, and administration of grant funds. Thus, they are concerned with the design and operating effectiveness of all relevant controls used in ensuring compliance with laws, regulations, and the provisions of contracts or grant agreements relating to federal award programs.

The controls relevant to ensuring compliance with federal awards requirements are important factors in assessing the risk of noncompliance and designing effective compliance tests. OMB Circular A-133 addresses this fact by requiring the auditor to obtain an understanding of, plan, and test internal control sufficient to support a low assessed level of control risk for major programs. The requirement to test internal control is not relative to any efficiency decision by the auditor. It is required even if the auditor has excluded the effect on controls from the relevant risk assessment for efficiency reasons in the audit of the financial statements. OMB requires that the auditor perform testing of internal control for the assertions relevant to the major program compliance requirements. Accordingly, not all controls that may be relevant to the financial statements or the financial reporting system would need to be tested. When determining which controls to test, the auditor should—

- gain an understanding of the applicable compliance requirements for each of the major programs,
- determine which compliance requirements have a direct and material effect on the major program,
- determine the applicable controls for those compliance requirements,
- determine what controls are in place to prevent or detect material noncompliance, and

- document and plan tests of those controls to support a low assessed level of control risk.

A significant consideration in determining which controls to test in a compliance audit is the importance of identifying transaction streams; i.e., transaction types within transaction classes. In other words, within the class of expenditure transactions, the auditor will be particularly concerned with transaction streams of expenditures charged to federal programs. An effective approach is usually to review the federal award agreement, identify all transaction streams associated with the agreement, and then identify relevant controls for those transaction streams.

Ineffective Internal Control. The OMB recognizes that in some situations, planning for and performing tests of controls to support a low assessed level of control risk may not be appropriate. When the auditor has determined that internal control over major program compliance is not in place or is not functioning effectively, it is not necessary to plan for or test the internal control over the affected compliance requirements. However, the auditor should report the internal control deficiency in the schedule of findings and questioned costs, assess the control risk at high, and consider whether additional compliance tests are necessary due to the ineffective internal control.

Auditors should be cautious about not planning and performing tests of internal control because of identified weaknesses. If internal control over some of the major program compliance requirements may be functioning, appropriate tests should be made. For example, if the auditor has determined that there is a pervasive internal control weakness, such as a lack of segregation of duties, that would not be a reason to eliminate testing of other controls that may be in place, such as other controls over cash disbursements or verification of eligibility of individuals to participate in a program.

Paragraph 9.27 of the GAS/A-133 AICPA Audit Guide further clarifies that the auditor's assessment of the effectiveness of internal control over compliance in preventing, detecting, and correcting noncompliance is determined for each major program and is relative to each individual type of compliance requirement or to an audit objective identified in the Compliance Supplement. For example, if a lack of segregation of duties causes controls over eligibility to be ineffective, the auditor should:

- Report the lack of segregation of duties relative to eligibility as a significant deficiency or a material weakness
- Assess control risk related to eligibility requirements at the maximum.
- Consider the lack of effective control when designing the nature, timing, and extent of procedures to test compliance with the major program's eligibility requirements. In most cases, the extent of testing would need to be expanded.

AUDITING COMPLIANCE WITH THE COMPLIANCE REQUIREMENTS

In addition to requiring that the audit be performed in accordance with the Yellow Book, Section 500(d)(1) of OMB Circular A-133 requires the auditor to determine whether the client 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. For clusters, materiality is based upon the cluster rather than the individual programs within the cluster. To accomplish this, the Circular directs the auditor to the Compliance Supplement to determine the compliance requirements for testing. The auditor then should gain an understanding of the appropriate compliance requirements sufficient to determine the nature, timing, and extent of audit procedures necessary to provide a basis for expressing an opinion on compliance.

OMB Circular A-133 requires that compliance testing include tests of transactions and other auditing procedures as considered necessary. Because of the small population involved or the type of evidence available, the auditor may find that the testing of certain compliance requirements do not lend themselves to transaction testing. In those cases, the requirements are usually tested by inquiry, observation, and inspection. Other requirements, however, leave documentary evidence of compliance and involve large populations (e.g., requirements related to eligibility and allowable costs/cost principles). These requirements will generally be tested using transaction testing.

Compliance testing may be performed (a) concurrently with tests of controls, (b) as substantive testing, or (c) as a combination of both. The GAS/A-133 AICPA Audit Guide, paragraph 10.33, states that the auditor should consider

both audit risk and materiality related to each major program and for each direct and material compliance requirement related to each major program when determining the nature, timing, and extent of the compliance testing. 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 entity complied, in all material respects, with the direct and material compliance requirements for each major program.

Selecting Transactions to Test

Section 500(d)(4) of OMB Circular A-133 states that “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.” The selection of transactions for testing would be based on the auditor’s professional judgment. The *Federal Cognizant Agency Audit Organization Guidelines*, Section III.B.1.(d), indicate the cognizant agency for audit will provide technical assistance to auditors with questions concerning tests of charges. Although these guidelines predate the 1997 OMB Circular A-133, the guidance concerning aspects of the cognizant or oversight agency for audit’s responsibility for providing technical audit advice and liaison (a 1997 Circular requirement) continues to be good general information.

Testing Transactions for Compliance with Requirements Applicable to Major Federal Programs

Tests of compliance with requirements applicable to major federal programs are substantive tests. Section 500(c) of OMB Circular A-133 and Paragraph 6.24 of the GAS/A-133 AICPA Audit Guide indicate the auditor should 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. According to the GAS/A-133 AICPA Audit Guide, Paragraph 10.31, 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.” While a low assessed level of control risk is not required to be achieved, the auditor’s assessment of 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 internal controls) “contributes to the auditor’s evaluation of the risk that material noncompliance exists in a major program,” according to Paragraph 6.24. That assessment, together with the auditor’s assessment of inherent risk and fraud risk, also provides audit evidence concerning the risk that noncompliance may exist. As a result, the auditor’s control risk assessment is an important factor in determining the extent of compliance tests.

In determining the nature of the tests of compliance with requirements governing major federal programs, the auditor should consider the character of those requirements. If the entity has controls designed to ensure compliance with laws, regulations, and the provisions of contracts or grant agreements, the auditor may be able to restrict the extent of the substantive tests of compliance with those requirements. To do so, the auditor would have to perform tests of the design and operating effectiveness of the controls over compliance with laws, regulations, and the provisions of contracts or grant agreements. In a single audit, it may be efficient to attempt to reduce the extent of these substantive tests of compliance because OMB Circular A-133 requires tests of controls related to compliance for all single audits. Paragraph 6.34 of the GAS/A-133 AICPA Audit Guide addresses the opportunity for auditors to reduce substantive tests of compliance and increase audit efficiency because of OMB Circular A-133’s internal control testing requirements.

Paragraph 10.30 of the GAS/A-133 AICPA Audit Guide states that “the auditor should use knowledge gained in the inherent risk assessment process to (1) to identify types of potential noncompliance, (2) to consider 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.” The results of tests of controls impact the substantive tests of compliance that are necessary to provide the auditor with sufficient evidence to support an opinion on compliance for each major program. Tests of controls over compliance and tests of compliance may be performed concurrently and serve as either dual-purpose tests or triple-purpose tests.

Audit Considerations Relating to Indirect Costs

Under OMB Circular A-133 and the Compliance Supplement, when indirect costs or allocated costs have a direct and material effect on a major program, the auditor is responsible for determining the propriety of costs charged to

cost pools that are used to calculate an indirect cost rate (or allocated through a cost allocation plan) in the year in which the charges affect a major program. Timing considerations relating to testing such costs are addressed in the preamble to the 1997 OMB Circular A-133 and in Part 3 of the Compliance Supplement. The preamble of OMB Circular A-133 notes that “because it may not be practical to perform such tests retroactively (e.g., when there is a change in auditors), OMB encourages the auditor to perform tests of costs charged to cost pools during the period when the actual costs were incurred or during the period when the proposal or plan is finalized, rather than waiting until the period when the rate was applied or in which the costs were allocated.” The timing considerations and the impact on the audit process are illustrated by the following example provided in the preamble to OMB Circular A-133.

Assume that the costs charged to cost pools during fiscal year 1997 (the base year) are the basis for an indirect cost rate proposal (IDCRP) submitted in 1998. The resulting negotiated indirect cost rate would be applied in 1999. This situation creates several audit timing issues:

- The audit for 1997 (which covers the applicable cost pools) may be completed before the IDCRP is submitted. Therefore, the auditor cannot complete testing of the IDCRP as part of the 1997 audit.
- If the auditor waits to test the IDCRP until 1999 (the year when the IDCRP is initially used to charge federal awards), the auditor would be testing 1997 records, which would then be two years old.

If the indirect cost rate is the basis for material charges to a major program in 1999, the auditor for 1999 is required to obtain appropriate assurance that the costs collected in the cost pools and allocation methods are in compliance with the applicable cost principles. The Compliance Supplement presents the following as acceptable options the auditor may use to obtain this assurance:

- Perform interim testing of the costs charged to cost pools (e.g., determine from management the cost pools that management expects to include in the IDCRP and test the costs charged to those pools for compliance with the cost principles circulars) during the 1997 audit. As part of the 1998 audit, complete testing and verify management's representation against the IDCRP finally submitted in 1998.
- Test costs charged to the cost pools underlying the IDCRP during the 1998 audit (the year immediately following the base year). This would require testing of 1997 transactions.
- Wait until 1999, the year in which charges from the indirect cost rate are material to a major program and test costs charged to cost pools (1997) used to prepare the IDCRP. This is a much more difficult approach because it requires going back two years to audit the cost charged to cost pools of the base year.

The Compliance Supplement notes that selecting one of the first two methods allows the testing of the costs charged to the cost pools to occur closer to the time when the transactions occur (which makes the testing easier to perform). As a result, if there are audit exceptions, corrective action may be taken earlier to minimize questioned costs. This should also make audit exceptions easier to resolve. The Supplement notes that “when material indirect costs are charged to any Type A program . . . , auditors are strongly encouraged to use one of the first two methods. This is because under the risk-based approach, . . . all Type A programs are required to be considered major programs at least once in every three years and the [indirect cost rate] is usually used to charge Federal awards for at least three years.”

In addition, when an IDCRP has been tested in a prior year, the auditor is only required to perform tests to ascertain if there have been material changes to the cost accounting practices in subsequent years. The auditor should coordinate testing of indirect costs with the auditee (and the cognizant agency for indirect cost negotiation, if appropriate). The Compliance Supplement recommends that the auditor consult with the auditee in the base year and the year in which the IDCRP is submitted to determine the best (e.g., most efficient) alternative under the circumstances.

Evaluating Results of Testing

In a single audit, the objective of testing transactions for compliance with laws, regulations, and provisions of contracts and grant agreements is to express an opinion on whether the entity has complied, in all material

respects, with applicable compliance requirements, noncompliance with which *could* have a material effect on each major program. For purposes of assessing compliance, a “material event of noncompliance” is one that could result in the entity having to refund federal monies or make other restitution in an amount that would be material to the particular federal awards program. Or, an out-of-compliance entity could be denied reimbursement of program expenditures that had already been made.

It can be difficult to assess the materiality of instances of noncompliance, because the auditor is not in a position to completely understand some of the implications of instances of noncompliance that might cause federal officials to eliminate or discontinue federal programs, disallow charges, or demand refunds. However, OMB Circular A-133 does not require an opinion that noncompliance *will* have a material effect, but only that noncompliance *may* have a material effect. It will help the auditor to remember that federal agencies have determined that noncompliance with the requirements listed in the Compliance Supplement could have a material effect.

Paragraph 10.09 of the GAS/A-133 AICPA Audit Guide states that reaching a conclusion about whether the effect of noncompliance is 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.” SAS No. 74 (AU 801.17) lists the following factors the auditor should consider in evaluating the effect of identified instances of noncompliance on the program:

- a. The frequency of noncompliance identified in the audit.
- b. The adequacy of a primary recipient's system for monitoring subrecipients and the possible effect on the program of any noncompliance identified by the primary recipient or the subrecipients' auditors.
- c. Whether any instances of noncompliance identified in the audit resulted in questioned costs, and, if they did, whether questioned costs are material to the program.

Although the auditor's opinion relates only to material noncompliance, OMB Circular A-133 requires the auditor to report certain findings, questioned costs, and other noncompliance that would not be considered material.

Comparison of Compliance Testing Requirements—GAAS, GAS, Single Audit Act Amendments, and OMB Circular A-133

Exhibit 1-1 compares the requirements to perform compliance tests under generally accepted auditing standards (GAAS), *Government Auditing Standards*, the Single Audit Act Amendments, and OMB Circular A-133.

Exhibit 1-1**Comparison of Compliance Testing Requirements^a**

	Fieldwork Responsibilities	Reporting Responsibilities
Generally accepted auditing standards	<p>The auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 54, <i>Illegal Acts by Clients</i> (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 317), as described in SAS No. 74, <i>Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance</i> (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 801). (It generally has been interpreted under GAAS that the phrase "laws and regulations" in SAS No. 54 implicitly includes provisions of contracts or grant agreements.)</p> <p>SAS No. 54 also requires audit procedures if specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements.</p>	<p>The auditor should adequately inform those charged with governance, orally or in writing, about any illegal acts that the auditor becomes aware of during the audit unless they are clearly inconsequential. (It generally has been interpreted under GAAS that the phrase <i>illegal acts</i> in SAS No. 54, which is defined as violations of laws or governmental regulations, implicitly includes violations of provisions of contracts or grant agreements.) SAS No. 114, <i>The Auditor's Communication with Those Charged with Governance</i>, requires written communication of significant findings if, in the auditor's judgment, oral communication would not be adequate.</p>
<i>Government Auditing Standards</i>	<p><i>Government Auditing Standards</i> also 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. (<i>Government Auditing Standards—July 2007 Revision</i>, Paragraph 4.10.) (See the discussion about provisions of contracts or grant agreements in the item above on generally accepted auditing standards.)</p>	<p>The auditor should issue a written report describing the scope of the auditor's testing of compliance with laws, regulations, and provisions of contracts or grant agreements and presenting the results of those tests. (An opinion on compliance is not required, but is permitted if sufficient work was performed.) (<i>Government Auditing Standards—July 2007 Revision</i>, Paragraph 5.08.)</p> <p>The auditor's written report should identify all fraud and illegal acts unless they are inconsequential and material violations of provisions of contracts or grant agreements. The auditor should report violations of provisions of contracts or grant agreements that are less than material but more than inconsequential in a separate written communication. (<i>Government Auditing Standards—July 2007 Revision</i>, Paragraphs 5.10, 5.15, and 5.16.)</p>

	Fieldwork Responsibilities	Reporting Responsibilities
Single Audit Act and Circular A-133	The auditor should determine whether the entity complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that 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.

Note:

- ^a In 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), 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.

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SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Which of the following statements concerning the Compliance Supplement is correct?
 - a. Assisting auditors in planning and performing audits in accordance with the Single Audit Act Amendments of 1996 and OMB Circular A-133 is the purpose.
 - b. Revisions have been made annually since 1997. The newest update is effective for audits of fiscal years beginning after December 31, 2006.
 - c. Responsibility lies with Congress for annually providing OMB updates to the Compliance Supplement.
 - d. The compliance requirements for governmental units are addressed in the Compliance Supplement. Nonprofit Organizations are not covered.
9. The concepts of matching, level of effort, and earmarking require that—
 - a. subrecipients be monitored.
 - b. procurement, suspension, and debarment are applied when infractions occur.
 - c. organizations receiving federal funds contribute their own resources in a specified ratio.
 - d. eligibility for funds is verified.
10. The Compliance Supplement lists audit procedures for testing compliance. How much authority do these procedures hold?
 - a. They are required procedures.
 - b. They are suggested procedures.
 - c. They are considered a “safe harbor.”
11. The Yellow Book and OMB Circular A-133 require reports on internal control. Why are internal controls important?
 - a. Periodic monitoring is always inadequate.
 - b. Grantor agency reviews are standardized.
 - c. They can provide continuous monitoring.
 - d. Agency Inspectors General only investigate possible litigation or crimes.
12. In auditing compliance 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, which statement is correct?
 - a. Audit transaction testing should be used for the requirement of documentary evidence of compliance and involve large populations.
 - b. Tests of transactions and other auditing procedures are specifically stated for each type of major program.
 - c. Inquiry, observation and inspection should be used on the large populations that do not lend themselves to transaction testing.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. Which of the following statements concerning the Compliance Supplement is correct? **(Page 18)**
- a. **Assisting auditors in planning and performing audits in accordance with the Single Audit Act Amendments of 1996 and OMB Circular A-133 is the purpose. [This answer is correct. The supplement is an important source of information for auditors for understanding a program's objectives, procedures, and compliance requirements.]**
 - b. Revisions have been made annually since 1997. The newest update is effective for audits of fiscal years beginning after December 31, 2006. [This answer is incorrect. The newest update is effective for audits of fiscal years beginning after June 30, 2008.]
 - c. Responsibility lies with Congress for annually providing OMB updates to the Compliance Supplement. [This answer is incorrect. Funding federal agencies are the responsible parties to get updates to OMB.]
 - d. The compliance requirements for governmental units are addressed in the Compliance Supplement. Nonprofit Organizations are not covered. [This answer is incorrect. Both governmental units and nonprofit organizations are addressed in the Compliance Supplement.]
9. The concepts of matching, level of effort, and earmarking require that— **(Page 20)**
- a. subrecipients be monitored. [This answer is incorrect. These are concepts, which are compliance requirements.]
 - b. procurement, suspension, and debarment are applied when infractions occur. [This answer is incorrect. All of the concepts are compliance requirements, but the concepts of matching, level of effort, and earmarking do not require that procurement, suspension, and debarment take place when issues of noncompliance occur.]
 - c. **organizations receiving federal funds contribute their own resources in a specified ratio. [This answer is correct. These three concepts are concepts applied to organizations to ensure that their own resources are applied in a specified way in accordance with contracts or grant agreements.]**
 - d. eligibility for funds is verified. [This answer is incorrect. Eligibility for funds is verified during compliance whereas the concepts mentioned are specific compliance issues, which ensure that an organization's own resources are applied in a specified way in accordance with contracts or grant agreements.]
10. The Compliance Supplement lists audit procedures for testing compliance. How much authority do these procedures hold? **(Page 22)**
- a. They are required procedures. [This answer is incorrect. The audit procedures included in the Compliance Supplement are not required.]
 - b. **They are suggested procedures. [This answer is correct. The auditor's responsibility is to determine the nature, timing, and extent of the audit procedures that are necessary to meet the audit objectives. The auditor must use judgment to determine this. The procedures listed are suggestions and should not be considered a "safe harbor."]**
 - c. They are considered a "safe harbor." [This answer is incorrect. The audit procedures should not be considered a safe harbor. Auditors need to understand this.]

11. The Yellow Book and OMB Circular A-133 require reports on internal control. Why are internal controls are important? **(Page 25)**
- a. Periodic monitoring is always inadequate. [This answer is incorrect. Periodic monitoring can be an effective technique.]
 - b. Grantor agency reviews are standardized. [This answer is incorrect. Grantor agency reviews are not standardized and various techniques can be used.]
 - c. They can provide continuous monitoring. [This answer is correct. Internal controls are important because they can provide continuous monitoring.]**
 - d. Agency Inspectors General only investigate possible litigation or crimes. [This answer is incorrect. Agency Inspectors General investigate various agency issues which could include possible litigation, crime investigations, as well as fiduciary issues and management effectiveness reviews.]
12. In auditing compliance 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, which statement is correct? **(Page 26)**
- a. Audit transaction testing should be used for the requirement of documentary evidence of compliance and involve large populations. [This answer is correct. An example of this is the requirements related to eligibility and allowable costs/cost principles.]**
 - b. Tests of transactions and other auditing procedures are specifically stated for each type of major program. [This answer is incorrect. The auditor should use whatever tests he/she considers necessary according to OMB Circular A-133.]
 - c. Inquiry, observation and inspection should be used on the large populations that do not lend themselves to transaction testing. [This answer is incorrect. This is correct concerning *small* populations.]

QUESTIONED COSTS

Section 105 of OMB Circular A-133 defines a questioned cost as a cost that is questioned by the auditor because of an audit finding:

- 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.
- Where the costs, at the time of the audit, are not supported by adequate documentation.
- Where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

The auditor should always consult the relevant audit requirements when testing for compliance. However, some examples of expenses that would usually be considered questioned costs if charged to a federal program include the following:

- Unsupported transactions; e.g., canceled checks for which supporting vendors' invoices cannot be located.
- Lobbying expenses.
- Entertainment expenses.
- Fund-raising expenses.
- Capital expenditures, unless made with the prior approval of the funding agency.
- Any expenses that exceed the funding agency's budget flexibility guidelines.

The auditor may find it helpful to refer to "List of Selected Items of Cost Contained in OMB Cost Principles Circulars," in Part 3 of the Compliance Supplement for examples of both allowable and unallowable costs.

Noncompliance by a recipient with a compliance requirement governing federal awards may result in charges to the federal award being classified as a disallowed cost. However, the granting agency, cognizant or oversight agency for audit, or pass-through entity determines whether, in fact, a cost is disallowed. The auditor, based on the results of the tests of compliance, only questions that the cost charged to a federal program may not be in compliance with the appropriate requirements set forth in laws, regulations, contracts, or grant agreements. Upon determining that a questioned cost is disallowed, a funding agency may choose to not reimburse the recipient for the cost or require that funds already expended be refunded.

Effect of Questioned Costs on the Major Program Compliance Opinion

Paragraph 10.53 of the GAS/A-133 AICPA Audit Guide states that in evaluating the effect of questioned costs for purposes of forming an 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)." This guidance is also included in SAS No. 74 (AU 801.18) and in Section 510(a)(3) of OMB Circular A-133. AU 801.18 continues on to state that when sampling is used, "the auditor should project the amount of known questioned costs identified in the sample to the items in the major . . . program from which the sample was selected."

Generally, the auditor is not required to project questioned costs resulting from a *nonsampling* application to the population from which they were drawn or to perform any additional procedures to determine the effect of any questioned costs. OMB Circular A-133 does not require that the auditor expand the scope of a sampling application (test additional transactions) to determine the effect of questioned costs determined by the sampling application.

However, SAS No. 74 at AU 801.18 requires, for purposes of forming an opinion as to compliance with laws and regulations, that the auditor project the results of any sampling application (but need not report the amount of projected questioned costs). Also, qualitative considerations, such as deliberate instances of noncompliance or other circumstances of specific questioned costs, may cause the auditor to expand the original sample size in order to limit sampling risk or to more precisely estimate the extent of questioned costs, or may cause the auditor to question and report all costs charged to a program. For example, suppose the auditor tested 60 payroll transactions and found the same instance of noncompliance in each. He would report the number of items and their total in the payroll population tested and report that there was no reason to believe the untested transactions were conducted differently than the ones tested.

Effect of Questioned Costs on the Financial Statements

Because a questioned cost may not be reimbursed or may have to be refunded, noncompliance with compliance requirements may have a material effect on the financial statements. The auditor should consider the implications of questioned costs on the financial statements; that is, the need to record a liability or disclose a contingent liability for questioned costs. The materiality of the uncertainty would be assessed in relation to the financial statements. As discussed in Paragraph 6.30 of the GAS/A-133 AICPA Audit Guide, there is a lower materiality level for reporting findings in the schedule of findings and questioned costs (Circular A-133 audit finding materiality) that should not be confused with materiality levels used for planning and performing the single audit; expressing an opinion on the entity's compliance with requirements having a direct and material effect on each major program; and planning, performing, evaluating the results of, and reporting on the financial statement audit. [Note that Circular A-133 audit finding materiality is defined in OMB Circular A-133, Section 510(a), and materiality for the single audit compliance opinion is at the program level, whereas materiality for financial statement adjustment, disclosure, or report modification is at the financial statement level for nonprofit organizations and the opinion unit level for governments. Thus, an instance of noncompliance or a questioned cost will not automatically be material to the individual major program or to the financial statements.]

REPORTING ON COMPLIANCE

The auditor must consider the impact of known and projected instances of noncompliance at two levels when reporting on compliance—first, at the program level and then, at the financial statement level (i.e., for governmental entities this would be relative to the materiality level set for the financial statements being reported on). Several individual immaterial instances of noncompliance need to be assessed to determine if, in the aggregate, they could have a material effect. Since the auditor is expressing an opinion on each major program and not on the aggregate of all major programs, reaching a conclusion about whether the instances of noncompliance, either individually or in the aggregate, are material to a major program dictates consideration of the types and nature of the noncompliance as well as the actual and projected effect on each major program to which the noncompliance relates. Noncompliance that is material to one program may not be material to another program of a different size or nature.

The auditor should relate the number of instances of noncompliance that resulted in known questioned costs to the total population and the number of transactions examined. OMB Circular A-133 does not require the auditor to report likely questioned costs; however, the auditor should report all known questioned costs.

Reports and Other Communications versus Opinions on Compliance-related Matters

The distinction between a report or other communication and an opinion is important in compliance auditing. Stated in general terms, the distinction is that an opinion requires a sufficient scope of work to provide a reasonable basis for the opinion to be expressed, but a report or other communication simply states the findings based on a scope of work done for some other purpose. For example, an audit in accordance with GAAS requires a written communication of significant deficiencies and material weaknesses in internal control that the auditor becomes aware of during the audit, but does not obligate the auditor to search for internal control deficiencies to communicate. Usually, the scope of work for this type of communication is not sufficient for expressing an opinion on internal control. Expression of an opinion on management's assertions on the effectiveness of internal control over financial reporting is covered by Statement on Standards for Attestation Engagements No. 15 (AT 501, *An Examination of an Entity's Internal Control Over Financial Reporting That is Integrated With an Audit of Its Financial Statements*), which provides guidance to auditors who perform an examination of the design and operating effectiveness of internal

control over financial reporting in the context of an integrated audit (an audit of the entity's financial statements and an examination of its internal control). An integrated audit is planned and performed to achieve the objective of both engagements. SSAE No. 10, (AT 601, *Compliance Attestation*) provides auditors who are requested to issue a report on an entity's compliance with laws and regulations. The statement provides guidance for performing agreed-upon procedures and examination engagements and for preparing the different types of reports for each type of engagement.

A funding agency may require a report on compliance with laws and regulations. Usually a report simply describes the results of compliance tests performed as part of the audit of financial statements. On the other hand, an opinion usually requires expanded testing beyond that which is ordinarily required as part of the audit of financial statements and provides overall assurance on compliance rather than being limited to a statement of findings. The same distinction between a report and an opinion usually is relevant also to a funding source's requirements related to reporting on internal control.

The written requirements of some funding agencies may not use the terms *report* and *opinion* in a precise manner. Here, the auditor must consider examples provided in funding agency audit guides or other regulations. The wording of examples is usually a reliable indication of whether the funding agency intends to require a report of findings or an opinion. The auditor may also wish to obtain clarification directly from the cognizant agency or the funding agency.

Schedule of Findings and Questioned Costs

Section 510(a) of OMB Circular A-133 requires the auditor to report all findings (as defined) in the schedule of findings and questioned costs.

Auditor's Report on Compliance—Report Required by the Yellow Book

In a single audit, the auditor should issue a report on compliance prescribed by the Yellow Book. Essentially, the Yellow Book requires a report that describes the scope of the tests and the findings. When there are instances of noncompliance, the material instances of noncompliance should be described.

Auditor's Report on Compliance—Report Required by OMB Circular A-133

In addition to the compliance reporting responsibility imposed by the Yellow Book, OMB Circular A-133 imposes additional reporting responsibilities on the auditor. When reporting on compliance applicable to major programs under the provisions of OMB Circular A-133, the objective is to express an opinion on whether the audited entity has complied, in all material respects, with applicable laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a direct and material effect on *each* major federal awards program. The material effect, in this case, is measured in relation to each individual major program rather than the financial statements.

For an auditor to express an unqualified opinion on major program compliance, he or she must have applied all the audit procedures considered necessary. Any restrictions on the scope of the audit, whether imposed by the client or by circumstances such as the timing of the auditor's work, the inability to obtain sufficient appropriate audit evidence matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion. If the auditor qualifies or disclaims an opinion on major program compliance, the reasons for such should be described in the auditor's report. In addition, the auditor should consider the effects of such instances on his or her ability to express an unqualified opinion on the entity's financial statements. As discussed in Paragraph 12.21 of the GAS/A-133 AICPA Audit Guide:

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.

When the audit detects noncompliance that the auditor believes has a material effect on a major federal award program, the auditor should express a qualified or adverse opinion. The report should include the auditor's basis for such an opinion.

SUMMARY OF CHANGES TO THE OMB COMPLIANCE SUPPLEMENT

The OMB Compliance Supplement was most recently revised in March 2009. Following is a summary of changes in the Compliance Supplement since June 2008. Auditors may wish to retain copies of superseded Compliance Supplements until workpaper retention and peer review time periods elapse.

Changes in the March 2009 Compliance Supplement

The March 2009 Compliance Supplement, which supersedes the 2008 Compliance Supplement, is effective for audits of fiscal years beginning after June 30, 2008. Copies of the 2009 Compliance Supplement may be obtained from the OMB website at www.whitehouse.gov/omb/circulars_a133_compliance_09toc/ (available in Microsoft Word and PDF formats) or from the Government Printing Office by calling (202) 512-0132. The 2009 Compliance Supplement is stock number 041-001-00667-2.

The 2009 Compliance Supplement contains updated information on the previous federal programs, and adds five programs (seven of which is added to a cluster of and deletes six programs. Appendix V of the 2009 Compliance Supplement includes a summary of differences, by part, between the 2008 Compliance Supplement and the 2009 Compliance Supplement. Certain changes are highlighted in the following paragraphs.

Part 1—*Background, Purpose, and Applicability.* Changes include the following:

- Updated throughout for the effective date of the new Compliance Supplement.
- Updated the “Purpose and Applicability” section and the “Overview of This Supplement—Compliance Requirements (Part 3)” section to clarify that the auditor is responsible for achieving the stated audit objectives for the applicable compliance requirements and the suggested audit procedures are, as the name implies, only suggested.

Part 2—*Matrix of Compliance Requirements.* Changes include the following:

- Updated the matrix in Part 2 to add and delete programs and to make the matrix consistent with the Table of Contents and Part 4.

Part 3—*Compliance Requirements.*

- Updated “Introduction,” including coverage of the American Recovery and Reinvestment Act of 2009.
- Modified each Part—A through M—to include a subsection, “Source of Governing Requirements,” that includes references to 2 CFR Part 215, the OMB Circular A-102 Common Rule, and other potentially applicable requirements.
- Corrected citations in Part B, “Allowable Costs/Cost Principles;” under OMB Circular A-87, added web site for major local government and cognizant agency listings; and under OMB Circular A-21, added clarifying language regarding cognizant agencies.
- Updated Part C, “Cash Management,” to clarify applicability and make it consistent with 31 CFR Part 205, the Department of the Treasury’s regulatory implementation of the Cash Management Improvement Act.
- Updated Part H, “Period of Availability of Federal Funds,” to clarify testing under the Suggested Audit Procedures.
- Updated Part I, “Procurement and Suspension and Debarment,” to clarify suspension and debarment requirements.

- Updated Part L, "Reporting," to reflect changes in reporting requirements and to revise suggested audit procedures.
- Updated Part M, "Subrecipient Monitoring," to reflect requirements in OMB Circular A-133.
- Made other miscellaneous changes throughout for currency and clarity.

Part 4—Agency Program Requirements. Changes include:

- Added four new programs [10.582, 15.623, 15.635, and 20.219 (20.219 was added to an existing cluster)] and a new cross-cutting section. Deleted six programs [14.219, 17.263, 84.288, 84.290, 84.291, and 97.008].
- Updated numerous existing programs in the Compliance Supplement for program titles, references, new program requirements, program revisions, technical corrections, and clarifications.

Part 5—Clusters of Programs.

- Added CFDA 84.379 to the Student Financial Assistance Cluster and corrected the title of CFDA 93.342, where applicable.
- Updated the Student Financial Assistance Cluster to reflect changes to program requirements and other revisions and clarifications.
- Updated other clusters to reflect changes in program names and programs deleted from the Supplement.

Part 6—Internal Control.

- Added new coverage and clarified existing coverage in Part E, "Eligibility."

Part 7—Guidance for Auditing Programs Not Included in This Compliance Supplement.

Appendixes. There were no changes to Appendix I in the 2009 Supplement. Appendixes I, II, III, VIII and IX were updated to reflect current information.

- Appendix IV (Internal Reference Tables): This Appendix provides a listing of programs in Parts 4 and 5 that include section IV, "Other Information;" the Appendix also identifies programs currently identified as higher risk, pursuant to OMB Circular A-133, section 525(c)(2). This Appendix was updated for changes in the 2009 Compliance Supplement. It is important to note that this Appendix indicates that the Medicaid Cluster is the only program currently identified as higher risk. However, as discussed in paragraph 703.29, Appendix VII of the Compliance Supplement states that all programs with expenditures of Recovery Act funds should be considered as being "programs of higher risk" in accordance with OMB Circular A-133.
- Appendix V (List of Changes for the 2008 Compliance Supplement): This appendix provides a list of changes from the March 2007 Supplement to the 2008 Supplement.
- Appendix VI (Disaster Waivers and Special Provisions Affecting Single Audits):
 - Deleted coverage for programs which waivers or special provisions have expired.
- Appendix VII (Other OMB Circular A-133 Advisories):
 - Added coverage of the effect of the American Recovery and Reinvestment Act on single audits.
 - Added coverage of common audit deficiencies cited in the report on the "National Single Audit Sampling Project."

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. A questioned cost is defined by OMB Circular A-133 as a cost questioned by the auditor because of an audit finding arising from—
 - a. a violation of a law, regulation, contract or grant agreement.
 - b. an adequately documented expenditure.
 - c. a reasonable estimate of costs.
 - d. a cost that falls within the funding agency's budget flexibility guidelines.
14. Which costs would be allowable without question if charged to a federal program?
 - a. Entertainment expenses with appropriate documentation.
 - b. Fund-raising expenses with appropriate documentation.
 - c. Capital expenditures with prior approval.
 - d. Unsupported transactions.
15. Who has the final say on whether a questioned cost is disallowed?
 - a. The auditor.
 - b. The funding agency.
 - c. The agency in charge of accounting for the program.
 - d. The agency's legal office.
16. Which of the statements below is correct concerning reporting on compliance?
 - a. Noncompliance that is material to one program may not be material to another program.
 - b. OMB Circular A-133 requires the auditor to report likely questioned costs.
 - c. In compliance auditing there is no distinction between a report and an opinion.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. A questioned cost is defined by OMB Circular A-133 as a cost questioned by the auditor because of an audit finding arising from— **(Page 36)**
- a. **a violation of a law, regulation, contract or grant agreement. [This answer is correct. A questioned cost may result from an auditor detecting a violation of a law, regulation, contract or grant agreement.]**
 - b. an adequately documented expenditure. [This answer is incorrect. If an expenditure is adequately documented it will most likely not result in a questioned cost.]
 - c. a reasonable estimate of costs. [This answer is incorrect. If a reasonable estimate of costs is provided and can be verified, it will most likely not result in a questioned cost.]
 - d. a cost that falls within the funding agency's budget flexibility guidelines. [This answer is incorrect. If a cost falls within the funding agency's budget flexibility guidelines, it will most likely not result in a questioned cost.]
14. Which costs would be allowable without question if charged to a federal program? **(Page 36)**
- a. Entertainment expenses with appropriate documentation. [This answer is incorrect. Entertainment expenses are usually considered questioned costs and would not be allowable without question.]
 - b. Fund-raising expenses with appropriate documentation. [This answer is incorrect. Fund-raising expense is an example of a questioned cost if charged to a federal program.]
 - c. **Capital expenditures with prior approval. [This answer is correct. With prior approval, capital expenditures would be allowable.]**
 - d. Unsupported transactions. [This answer is incorrect. Unsupported expense is an example of a questioned cost and might not be allowable. An example of this might be a canceled check without a supporting vendor invoice to document what was purchased.]
15. Who has the final say on whether a questioned cost is disallowed? **(Page 36)**
- a. The auditor. [This answer is incorrect. The auditor simply has the authority to question the cost and does not make the determination of whether the questioned cost is ultimately allowable.]
 - b. **The funding agency. [This answer is correct. The funding agency determines whether the questioned cost is allowable.]**
 - c. The agency in charge of accounting for the program. [This answer is incorrect. The accounting office does not make the determination of whether the questioned cost is allowable.]
 - d. The agency's legal office. [This answer is incorrect. The legal office does not make the determination of whether the questioned cost is allowable.]

16. Which of the statements below is correct concerning reporting on compliance? **(Page 37)**

- a. **Noncompliance that is material to one program may not be material to another program. [This answer is correct. The auditor is expressing an opinion on each major program; not on the aggregate of all major programs. So materiality can be different for programs of differing size or nature.]**
- b. OMB Circular A-133 requires the auditor to report likely questioned costs. [This answer is incorrect. The auditor should report all known questioned costs, but is not required to report likely questioned costs.]
- c. In compliance auditing there is no distinction between a report and an opinion. [This answer is incorrect. An opinion requires a sufficient scope of work to provide reasonable basis for the opinion expressed; a report simply states the findings based on a scope of work done.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (GSATG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. The single audit covers two distinct areas, one is the financial statements, what is the other?
 - a. Forensics.
 - b. Compliance.
 - c. Legal.
 - d. Operations.
2. What is the Yellow Book that is published by the GAO?
 - a. A list of all federal grant awards categorized by major federal programs.
 - b. The book that contains government auditing standards.
 - c. A book of audit programs for federal agencies and programs.
 - d. The book, which contains federal laws and regulations that should be reviewed by auditors when planning an audit.
3. GAAS requires auditors to plan and perform an audit to provide reasonable assurance that _____ are free of material misstatement caused by errors, fraud, and illegal acts.
 - a. Financial records.
 - b. Entity's operations.
 - c. Financial statements.
 - d. Personnel records.
4. In Yellow Book engagements, auditors are responsible for designing testing to detect material misstatements. What would those material misstatements arise from?
 - a. Violations of provisions of contracts or grant agreements.
 - b. Abuse.
 - c. Fraud or illegal acts.
 - d. Abuse, fraud, or illegal acts, or violations of provisions of contracts or grant agreements.

5. What does a single audit require?
 - a. Audit testing for compliance with laws and regulations that could have a material effect on major state programs.
 - b. Testing at the state and federal level.
 - c. A review for federal awards annually when the award exceeds \$150,000.
 - d. Audit testing for compliance with laws and regulations that could have a material effect on major federal programs.
6. GAAS differs from the Yellow Book with respect to auditor responsibilities. What is the difference?
 - a. Both require auditors to detect contract violations, while the Yellow Book requires the same for detecting errors, fraud, and illegal acts.
 - b. The Yellow Book expands the responsibilities of the auditor to include other financial data significant to the audit objectives.
 - c. The Yellow Book expands the auditor responsibilities to include even immaterial violations.
 - d. GAAS expands the auditor responsibilities to include even immaterial violations.
7. What is the Yellow Book's definition of abuse?
 - a. A case where laws are broken.
 - b. Improper behavior as compared to a prudent person in the same circumstance and the same facts.
 - c. Immaterial violations of contracts or grant agreements.
 - d. Fraud or collusion.
8. When abuse indicators are detected, which is correct?
 - a. Abuse has occurred.
 - b. Abuse is likely to have occurred.
 - c. Audit procedures must be extended.
 - d. The issue is then reported to management in the management letter.
9. Which of the following would an auditor consider relevant when determining whether a situation or transaction constituting abuse is material to the financial statements?
 - a. The potential effect of continuous relationships with vendors, employees, and elected and appointed officials.
 - b. Whether the abuse is clear cut rather than a matter of judgment.
 - c. Frequency of the situation or transaction.
 - d. Whether the abuse is clear cut rather than a matter of judgment, the frequency of the situation or transaction, and the potential effect of continuous relationships with vendors, employees, and elected and appointed officials.

10. What should the auditor do after confirming that abuse has occurred?
- Report the abuse in a management letter.
 - Determine whether the abuse is material to the financial statements or other data significant to the audit objectives.
 - Report the issue to the agency's inspector general.
 - Determine whether the abuse is material to the financial statements or other data significant to the audit objectives and report the issue to the agency's inspector general.
11. The Catalog of Federal Domestic Assistance:
- would assist in determining which laws and regulations apply to a particular federal award.
 - is a policy manual used by federal agencies.
 - is the same as the Code of Federal Regulations.
 - contains the Compliance Supplement.
12. What does the compliance requirement of subrecipient monitoring mandate?
- A period of availability.
 - Equipment and real property management.
 - Cash management and reporting.
 - An adequate monitoring and follow-up system covering entities to which it has disbursed funds.
13. Continuous monitoring can best be achieved in an organization with which of the following?
- Periodic reviews.
 - Inspector General (IG) inspections.
 - Internal controls.
 - Grantor agency monitoring.
14. What might cause a cost to be questioned?
- A cost falls within the funding agency's budget flexibility guidelines.
 - A cost with adequate documentation.
 - A cost that falls within a normal range of prices charged for a commodity/service.
 - A cost that resulted from a violation of a provision of a law, regulation, contract or grant agreement.
15. Which type of expense would normally be considered allowable and chargeable to a federal program?
- Lobbying expenses.
 - Entertainment expenses.
 - Payroll expenses.
 - Capital expenditures.

16. If a questioned cost is disallowed by the funding agency, what are the funding agency's options?
- a. Require that funds already expended by the recipient be refunded.
 - b. Choose to not reimburse the recipient for the cost.
 - c. Depending on the severity of the breach, cancel the recipient's award.
 - d. Require that funds already expended by the recipient be refunded or choose to not reimburse the recipient for the cost.

Lesson 2: Subrecipient Considerations

INTRODUCTION

Federal funds awarded to a recipient are in many cases subsequently subgranted or subawarded to other governmental or nonprofit organizations. Congress and the OMB recognized the need to address these “pass-through” funds in the Single Audit Act Amendments of 1996 and OMB Circular A-133. Section 7501(a)(4) of the Single Audit Act Amendments and Section 105 of Circular A-133 define federal awards as “Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities.” Under this arrangement, the entity receiving the award directly from the federal agency is usually referred to as the “pass-through entity,” and the entity receiving the award from the pass-through entity is generally referred to as the subrecipient.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify and explain the difference between a subrecipient and a vendor.
- List the responsibilities of the pass-through entity, subrecipient, and auditor and discuss the Compliance Supplement's suggested audit procedures.
- Apply audit requirements for pass-through entities, subrecipients, and vendors and describe a limited scope engagement.

Authoritative Literature

The authoritative literature that establishes requirements or provides suggestions concerning subrecipient considerations include the following:

- Single Audit Act Amendments of 1996.
- OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.
- *OMB Circular A-133 Compliance Supplement* (Compliance Supplement).
- AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide).

Background

Single audit requirements have made critical the question of whether the entity receiving the subgrant is a “subrecipient” or a “vendor.” Subgrant relationships should not be confused with vendor relationships because of the significant difference in audit requirements relating to each type of relationship. Governmental and nonprofit “subrecipients” expending federal awards of \$500,000 or more annually must be audited in accordance with OMB Circular A-133. “Vendors” are not required to be audited in accordance with OMB Circular A-133 regardless of the type of organization. Also, compliance requirements exist for monitoring the performance of subrecipients but usually not for vendors. Section 210(f) of OMB Circular A-133 states:

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.

Grant and audit statutes, as well as various policies issued by the OMB, federal agencies, and other groups, have attempted to define the attributes of subgrants and contracts under grants.

Definition of Subrecipient

A *subrecipient* is defined in OMB Circular A-133, Section 105, as “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 direct recipient of federal awards under other agreements or programs. For example, a nonprofit organization may be considered a pass-through entity, subrecipient, and/or a vendor under different federal award programs.

Definition of Vendor

OMB Circular A-133, Section 105, defines a vendor as “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.”

Subgranting

Nonprofit and governmental organizations may receive subgrants from state and local governments subject to the Common Rule implementing OMB Circular A-102, *Grants and Cooperative Agreements with State and Local Governments*. The Common Rule provides states flexibility in making subgrants to other governments by permitting the states to use their own laws and procedures but directs local government grantees to pass through all of the Rule’s provisions to their governmental subrecipients. Notably, the Common Rule is silent on subgrants to nonprofit organizations, which allows states to be more restrictive in how they award funds to universities and nonprofits than to governments. The Common Rule applies only to governmental entities while nonprofit organizations should follow OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations*.

The Common Rule and OMB Circular A-110 make a significant effort to define subgrants, contracts under grants, subrecipients, and vendors. For example, the Common Rule contains separate sections that address each type of document. Section 36 addresses procurement of goods and services under a grant while Section 37 covers subgrants.

The vagueness of federal guidance on subgrantees and the nature of subgrant documents has forced federal fund recipients and their auditors to sort out the type of relationship a particular subgrant creates and the audit coverage warranted. Unfortunately, the answer is seldom included in audit requirements alone. Other guidance dealing with grants management must also be considered.

Basic Considerations

The auditor, along with the grantee, can review the features of each agreement to determine whether it appears more like a purchase or a subgrant. Following is a list of some of the many characteristics that can be considered:

- a. *Competition.* Grants are not required to be issued on a competitive basis, while procurement contracts will usually be issued based on free and open competition.
- b. *Multiple Awards.* Federal grant awards are usually issued to multiple recipients, whereas purchase contracts usually select only one vendor to provide the required goods or services.
- c. *Elements of Cost.* Subgrantees normally are reimbursed only for incurred allowable cost, while vendors are paid some amount above cost (profit).
- d. *Risk.* Vendors assume most of the risk for performance on a contract.
- e. *Cost Participation.* Subgrantees are many times required to provide matching funds or share in the cost of a grant program, whereas cost sharing would be highly unlikely in vendor agreements.
- f. *Selection Criteria.* For subgrants, generally a demonstrated need for the funds is most important, whereas for a vendor the ability to deliver the product or service takes precedence.

- g. *Purpose.* In a subgrant, the primary grantee is providing assistance to the subgrantee for the subgrantee's program, whereas in a vendor contract the primary grantee is hiring help for its own program.
- h. *Scope of Services.* For vendor procurements, the goods or services being purchased are normally spelled out in the contract. In a subgrant transaction, however, only the program details are identified in the grant document.
- i. *Terms and Conditions.* Special terms and conditions may be imposed unilaterally by primary grantees on subgrantees. For procurement contracts, however, special terms and conditions are usually not included, or, if included, they must be agreed to by the vendor at the time of the award.
- j. *Ownership of Property.* When real or personal property is purchased by a subgrantee with federal funds, the primary grantee retains an interest in the property. If the property is subsequently sold or the program is discontinued, the net proceeds from the sale of the property or the property itself usually must be returned to the primary grantee. For vendor contracts, where the vendor purchases equipment to assist in providing the goods or services, the vendor usually retains title to such property.
- k. *Termination.* Generally, a grant or subgrant can be unilaterally terminated by the granting agency only for cause. A procurement contract, on the other hand, can be terminated for the convenience of the awarding agency.

Distinguishing between Subrecipients and Vendors

Subrecipients. A subrecipient is defined as an entity that receives federal awards from a pass-through entity to carry out or administer a program. Section 210(b) of OMB Circular A-133 indicates that the distinguishing characteristics of a subrecipient include:

- a. Determining eligibility for assistance.
- b. Measuring performance against meeting the objectives of the program.
- c. Programmatic decision-making responsibility.
- d. Having responsibility for applicable program compliance requirements.
- e. Using passed-through funds to carry out a program of the subrecipient as compared to providing goods or services for a program of the pass-through entity.

As discussed in Paragraph 11.14 of the GAS/A-133 AICPA Audit Guide, an entity can be both a recipient and a subrecipient.

Examples of typical pass-through entity–subrecipient relationships are as follows:

- a. A state department of transportation receives federal awards which are then disbursed to various county governments within the state.
- b. A regional planning commission receives federal awards for housing the homeless or the feeding of the elderly and low-income that are disbursed to nonprofit organizations to support their housing or feeding programs.
- c. A national nonprofit organization receives federal awards that are allocated to other nonprofit organizations throughout the country.
- d. A state department of human services passes through federal awards to a nonprofit daycare facility.
- e. A local government passes through federal awards to a Meals-on-Wheels program.

Other examples are discussed in Paragraph 11.12 of the GAS/A-133 AICPA Audit Guide.

Vendors. A vendor is defined as an entity that is responsible for providing goods or services for the administrative support of a federal program. Section 210(c) of OMB Circular A-133 indicates that the distinguishing characteristics of a vendor include the following:

- a. Providing goods and services within normal business operations.
- b. Providing similar goods and services to many different purchasers.
- c. Operating in a competitive environment.
- d. Providing goods or services that are ancillary to the operation of the federal program.
- e. Not being subject to the compliance requirements of the federal program.

Some typical examples of a buyer-vendor relationship are:

- a. The purchase of building materials for home renovations by a city's housing office supported by federal awards.
- b. The purchase of medical services that are funded by a federal government program (Medicaid).
- c. The purchase of vocational training services (except for certain Job Training Partnership Act contracts).
- d. A government's purchase of supplies or equipment through a regional pooled purchasing program that was funded in part by federal assistance.

Other examples are discussed in Paragraph 11.13 of the GAS/A-133 AICPA Audit Guide.

The test for a subrecipient relationship is whether a subrecipient receives federal awards from a pass-through entity to carry out a program. The focus should be on whether the subrecipient is being paid for goods or services or is receiving funds to support a federal or state program. Advise your client to state clearly his or her intent in all vendor and subgrantee contracts.

Subgranting of federal awards is usually done on the basis of a properly completed and approved grant application. The form, features, and language of the agreement are the best sources for determining which type of relationship exists. Although, in many instances, procurements are made without written contracts or agreements, the lack of such an agreement or contract may indicate the presence of a subrecipient relationship.

The substance of the relationship is more important than the form of the agreement when making the determination of whether a subrecipient or vendor relationship exists. The determination may be difficult, requiring the use of professional judgment.

As a practical matter, auditors and grantees should look at each award to determine whether the majority of features makes it appear more like a purchase than a grant. The local, state, or federal cognizant, oversight, or grantor agency may be contacted for assistance in making these determinations.

To properly manage federal awards, recipient organizations should have a clear understanding of their responsibilities as pass-through entities or subrecipients of federal awards. Likewise, auditors of these organizations are responsible for obtaining knowledge of the requirements related to program operations and audits of federal awards. The roles of the pass-through entity, subrecipient, and the auditor in complying with federal single audit requirements are discussed in the following section.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. With respect to vendors and OMB A-133, which statement is correct?
 - a. Auditees are responsible for ensuring compliance for vendor transactions.
 - b. Vendors are required to be audited annually.
 - c. Subrecipients are also referred to as vendors.
 - d. Vendors expend awards received from a pass-through entity.
18. According to OMB Circular A-133, what is a subrecipient?
 - a. An individual that is a beneficiary of awards received from a pass through entity.
 - b. A non-federal entity that expends Federal awards received from a pass-through entity to carry out a Federal program.
 - c. May not be a direct recipient of federal awards under other agreements.
 - d. The same as a vendor.
19. In regard to the "Common Rule," which is correct?
 - a. The common rule provides federal entities flexibility in making subgrants to other government entities.
 - b. The common rule does *not* apply to governmental entities, but *does* apply to nonprofit organizations.
 - c. The common rule is used by states when making subgrants to other governments.
 - d. The common rule allows states to be less restrictive in how they award funds to universities than to governments.
20. At times an auditor must determine if an agreement between the granting agency and the recipient of funds is a subgrant or a purchase. Based on the characteristics listed below, which answer choice best describes a purchase contract for Lynnco?
 - a. Lynnco had to purchase some equipment for the project and the agency retains some interest in the property; they won the agreement after a competitive bid; and are reimbursed incurred allowed costs.
 - b. Lynnco was one of many having a similar agreement with this agency; there are many special terms and conditions made unilaterally by the agency; and the agency can unilaterally terminate the contract only for cause.
 - c. Lynnco had to demonstrate a need to the agency; the funds received assist Lynnco in their program; and the program details are identified in the agreement.
 - d. Lynnco assumes most of the performance risk on this agreement; they were hired by the agency to work on this program; and all services are spelled out in the agreement.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. With respect to vendors and OMB A-133, which statement is correct? **(Page 49)**

- a. **Auditees are responsible for ensuring compliance for vendor transactions. [This answer is correct. Section 210(f) of Circular A-133 states that “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.”]**
- b. Vendors are required to be audited annually. [This answer is incorrect. Payments for goods or services provided by a vendor are not considered federal awards under OMB Circular A-133. As a result, the audit requirement under this circular does not apply to vendors. However, if a vendor is responsible for ensuring some part of the federal program compliance, then the auditee must review the vendor’s records to ensure program compliance.]
- c. Subrecipients are also referred to as vendors. [This answer is incorrect. Subrecipients are not to be confused with vendors, Section 105 of OMB Circular A-133, defines vendors as a “dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a federal program.”]
- d. Vendors expend awards received from a pass-through entity. [This answer is incorrect. Subrecipients expend awards received from a pass-through entity.]

18. According to OMB Circular A-133, what is a subrecipient? **(Page 50)**

- a. An individual that is a beneficiary of awards received from a pass through entity. [This answer is incorrect. A subrecipient, according to OMB 133-A specifically excludes individuals that are beneficiaries of such a program from the definition.]
- b. **A non-federal entity that expends Federal awards received from a pass-through entity to carry out a Federal program. [This answer is correct. In addition, a direct recipient of federal awards under other agreements or programs might be defined as a subrecipient.]**
- c. May not be a direct recipient of federal awards under other agreements. [This answer is incorrect. A subrecipient may also be a direct recipient of other federal awards under other agreements or programs.]
- d. The same as a vendor. [This answer is incorrect. Subrecipients should not be confused with vendors because of the significant difference in audit requirements relating to each type of classification. A vendor provides goods or services for a price attributable to the value of those goods or services.]

19. In regard to the “Common Rule,” which is correct? **(Page 50)**

- a. The common rule provides federal entities flexibility in making subgrants to other government entities. [This answer is incorrect. The Common Rule does not apply to federal entities.]
- b. The common rule does *not* apply to governmental entities, but *does* apply to nonprofit organizations. [This answer is incorrect. The Common Rule applies *only* to governmental entities. Nonprofit organizations are covered in OMB Circular A-110.]
- c. **The common rule is used by states when making subgrants to other governments. [This answer is correct. The Common Rule provides states flexibility in making subgrants to other governments by allowing them to use their own laws and procedures, but directs local governments grantees to pass through all of the Rule’s provisions to their governmental subrecipients.]**

- d. The common rule allows states to be less restrictive in how they award funds to universities than to governments. [This answer is incorrect. Because the Common Rule is silent on subgrants to nonprofit organizations, states are allowed to be *more* restrictive in how they award funds to universities and nonprofits than to governments.]
20. At times an auditor must determine if an agreement between the granting agency and the recipient of funds is a subgrant or a purchase. Based on the characteristics listed below, which answer choice best describes a purchase contract for Lynnco? **(Page 50)**
- a. Lynnco had to purchase some equipment for the project and the agency retains some interest in the property; they won the agreement after a competitive bid; and are reimbursed incurred allowed costs. [This answer is incorrect. If the agreement were a purchase contract, Lynnco would retain title of the purchased equipment; the agreement would have been based on free and open competition; and Lynnco would be paid an amount above cost.]
- b. Lynnco was one of many having a similar agreement with this agency; there are many special terms and conditions made unilaterally by the agency; and the agency can unilaterally terminate the contract only for cause. [This answer is incorrect. If the agreement were a purchase contract, Lynnco would most likely be the only vendor providing the service, any special terms would be agreed to by Lynnco at the time of award; and the agency could terminate the agreement at their convenience.]
- c. Lynnco had to demonstrate a need to the agency; the funds received assist Lynnco in their program; and the program details are identified in the agreement. [This answer is incorrect. If this agreement were a purchase agreement, Lynnco would have demonstrated that they had the best ability to deliver the service, Lynnco would have been hired by the agency, not assisted; and the services being purchased would normally be spelled out in the contract.]
- d. **Lynnco assumes most of the performance risk on this agreement; they were hired by the agency to work on this program; and all services are spelled out in the agreement. [This answer is correct. These are all characteristics of a vendor agreement and would lead the auditor to determine that this is a purchase contract, not a subgrant.]**

RESPONSIBILITIES

Pass-through Entity Responsibilities

A pass-through entity assumes responsibility for complying with federal requirements when it accepts federal awards. That responsibility includes operating the program, maintaining property and financial records, arranging for audits, and assuring audit resolution. When the pass-through entity passes a grant through to a subrecipient, federal agencies hold the pass-through entity ultimately responsible for compliance at the subrecipient level. The pass-through entity is responsible for informing the subrecipient of applicable federal requirements as well as identifying of the source of funding and any additional administrative requirements imposed on the subrecipient.

Audit requirements can present problems for the pass-through entity because the requirements differ depending on the subrecipient's amount of federal expenditures, the awarding agency program regulations, and the terms and conditions of the specific award. The pass-through entity should first understand the audit requirements before those requirements are imposed on the subrecipient.

Pass-through Entity Responsibilities—OMB Circular A-133. Section 400(d) of OMB Circular A-133 places the following responsibilities on pass-through entities:

- a. 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.
- b. 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.
- c. 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.
- d. 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. [If the funds passed through to the subrecipient are the only federal funds it receives, then the subrecipient may qualify for a program-specific audit instead of a single audit.]
- e. 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.
- f. Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.
- g. 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 Circular A-133.
- h. Maintain subrecipients' report submissions (or other written notification when the subrecipient is not required to submit a reporting package) on file for at least three years from the date received.

The above responsibilities are discussed in Paragraph 11.19 of the GAS/A-133 AICPA Audit Guide.

Pass-through Entity Responsibilities—Compliance Supplement. The Compliance Supplement (Part 3, Section M) indicates that pass-through entities have the following responsibilities relating to subrecipients:

- a. *Award Identification.* At the time of the award, identifying to the subrecipient the federal award information (e.g., CFDA title and number, award name, name of federal agency) and applicable compliance requirements.
- b. *During-the-award Monitoring.* Monitoring the subrecipient's use of federal awards through reporting, site visits, regular contact, or other means to provide reasonable assurance that the subrecipient administers

federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.

- c. *Subrecipient Audits.* (1) Ensuring that subrecipients expending \$500,000 or more in federal awards during the subrecipient's fiscal year have met the audit requirements of OMB Circular A-133 and that the required audits are completed within nine months of the end of the subrecipient's audit period, (2) issuing a management decision on audit findings within six months after receipt of the subrecipient's audit report, and (3) ensuring that the subrecipient takes timely and appropriate corrective action on all audit findings. In cases of continued inability or unwillingness of a subrecipient to have the required audits, the pass-through entity shall take appropriate action using sanctions.
- d. *Pass-through Entity Impact.* Evaluating the impact of subrecipient activities on the pass-through entity's ability to comply with applicable federal regulations.

Pass-through Entity Responsibilities—Recovery Act. The American Recovery and Reinvestment Act of 2009 (Recovery Act) and related implementing guidance mandate the following responsibilities relating to subrecipients:

- a. Separately identify to each subrecipient and document at the time of the subaward and each disbursement of funds, the federal award number, CFDA number, and amount of Recovery Act funds.
- b. For Recovery Act funds passed through for an existing program, distinguish the incremental Recovery Act funds separately from regular subawards in the information provided in item a.
- c. Require the subrecipient to include information similar to that in item a. on their schedule of expenditures of federal awards.
- d. Inform subrecipients about federal agency information regarding requirements for Recovery Act awards.

OMB Circular A-133 Audit Threshold. The \$500,000 threshold applies to all federal awards expended by the subrecipient, not just those provided by a single pass-through entity. This raises a question for the pass-through entity. If the pass-through entity has to ensure that subrecipients expending \$500,000 or more annually in *total* federal awards (not just those provided by the pass-through entity) meet the audit requirements of OMB Circular A-133, to what extent does the pass-through entity have to investigate the subrecipient to make this determination? The answer is that the OMB does not expect the pass-through entity to perform extensive verification procedures to determine the subrecipient's total federal expenditures, only to estimate the total based on available information or to ask the subrecipient for the total. One way to facilitate the accumulation of information about subrecipients is for the pass-through entity to send a questionnaire to all subrecipients. The questions may include the expected amount of total federal awards expended and whether the subrecipient will have an audit performed in accordance with OMB Circular A-133. In addition, such a communication could also be used to advise (or remind) subrecipients of the requirements imposed on them. Alternatively, some pass-through entities require each subrecipient to (a) provide a listing of all direct and indirect federal funds received by the subrecipient as part of the grant application and (b) update the listing annually.

OMB Circular A-133 places the responsibilities listed previously on pass-through entities, regardless of the amount of pass-through awards provided to the subrecipient. Thus, pass-through entities are responsible for monitoring the activities of subrecipients whose federal expenditures fall below the single audit threshold.

Allowable Audit Costs. OMB Circular A-133 discourages pass-through entities from requiring single audits of subrecipients when single audits are not required under the Circular. Section 230(b)(2) of OMB Circular A-133 prohibits pass-through entities from charging single audit costs to federal awards for subrecipients that do not meet the \$500,000 threshold. If a pass-through entity requires a subrecipient which expends less than \$500,000 annually in total federal awards to have a single audit, the pass-through entity would have to pay for the audit with non-federal funds. Also, if the pass-through entity requests a subrecipient having a Circular A-133 audit to have a program tested as a major program, the pass-through entity would have to pay those incremental costs with non-federal funds. However, charges for limited scope audits to monitor its subrecipients are not prohibited provided the subrecipient is not required to have a single audit (i.e., such charges can be paid from federal awards if certain conditions are met). For this purpose, limited scope audits are agreed-upon procedures engagements

conducted in accordance with the AICPA's attestation standards that are *paid for and arranged by* the pass-through entity (not the subrecipient) and that 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. Charges for agreed-upon procedures engagements that address any other type of compliance requirement or that are arranged by the subrecipient cannot be paid from federal awards. A representative of OMB has publicly stated that if a pass-through entity contracts for an agreed-upon procedures engagement as permitted by OMB Circular A-133 that tests both federal and state laws, regulations, contracts, and agreements, a pro-rata share of the total cost of the engagement can be paid from federal awards. Pass-through entities should amend their subrecipient agreements accordingly.

Agreed-upon procedures engagements are covered by SSAE No. 10 (AT 201, *Agreed-Upon Procedures Engagements*) and SSAE No. 10 (AT 601, *Compliance Attestation*). Agreed-upon procedures engagements performed under the limited scope audit provisions of OMB Circular A-133 are discussed later in this lesson. In addition, *PPC's Guide to Nontraditional Engagements* provides guidance, including the usual PPC practice aids, that may be used to perform agreed-upon procedures engagements on subrecipient compliance.

Monitoring Activities. Because the \$500,000 threshold eliminates many subrecipients from single audit requirements, pass-through entities should consider whether additional monitoring procedures are necessary to ensure compliance by subrecipients that are not required to have an OMB Circular A-133 audit. Monitoring procedures are often less costly than a full OMB Circular A-133 audit and can easily be targeted to address subrecipient compliance. The Compliance Supplement (Part 3, Section M) provides the following examples of factors that may affect the nature, timing, and extent of the pass-through entity's during-the-award monitoring:

- *Program Complexity.* Programs with complex compliance requirements have a higher risk of noncompliance.
- *Percentage Passed Through.* The larger the percentage of program awards passed through, the greater the need for subrecipient monitoring.
- *Amount of Awards.* Larger dollar awards are of greater risk.
- *Subrecipient Risk.* Subrecipients may be evaluated as higher risk or lower risk to determine the need for closer monitoring. Generally, new subrecipients would require closer monitoring. For existing subrecipients, based on results of during-the-award monitoring and subrecipient audits, a subrecipient may warrant closer monitoring [e.g., the subrecipient has (a) a history of noncompliance as either a recipient or subrecipient, (b) new personnel, or (c) new or substantially changed systems].

In addition, the Compliance Supplement indicates that monitoring activities normally occur throughout the year and may take various forms. Subrecipient monitoring activities may include—

- *Reporting.* Reviewing financial and performance reports submitted by the subrecipient.
- *Site visits.* Performing site visits at the subrecipient to review financial and programmatic records and observe operations.
- *Regular Contact.* Regular contacts with subrecipients and appropriate inquiries concerning program activities.

In addition, a pass-through entity may arrange for agreed-upon procedures engagements for certain subrecipient activities, such as eligibility determinations. The Compliance Supplement notes that because the pass-through entity determines the procedures to be used and compliance areas to be tested, agreed-upon procedures engagements enable the pass-through entity to target the coverage to the areas of greatest risk. The costs of limited scope engagements and other monitoring procedures may be charged by the pass-through entity as direct costs to the program only if certain conditions are met.

In addition to the monitoring activities previously discussed, Paragraph 11.28 of the GAS/A-133 AICPA Audit Guide also notes that monitoring procedures may include appropriate inquiries concerning program activities.

Pass-through entities should monitor subrecipients during the grant period to ensure compliance with applicable federal requirements and attainment of performance goals. The pass-through entities are expected to establish a system to ensure that audits of their subrecipients meet the requirements of OMB Circular A-133. Such a system should include an initial review of each subrecipient report (audit report or program review report) to ensure that it conforms to the Circular. Quality control reviews of subrecipient audits by the federal cognizant agencies, however, are not required by the Circular. Management of pass-through entities may perform the following procedures when monitoring subrecipients:

- Maintain internal control over compliance by subrecipients sufficient to provide reasonable assurance that—
 - Subrecipients and other entities and individuals receiving federal funds meet the eligibility requirements.
 - Funds are disbursed to subrecipients only on an as-needed basis.
 - The disbursement of funds to subrecipients are supported by approved and properly completed reports submitted on a timely basis.
 - Refunds due from subrecipients are billed and collected timely.
- Review grant applications received from possible subrecipients to determine that applications are filed and approved on a timely basis and that each application includes a requirement that the subrecipients comply with the federal requirements set by the federal agency.
- Review periodic award reports (financial and technical) to determine they are received timely as required and investigate unusual items.
- Review subrecipient audit reports, and evaluate them for completeness and for compliance with applicable laws, regulations, contracts, and agreements.
- Evaluate audit findings; issue appropriate management decisions, if necessary; and determine if an acceptable corrective action plan has been prepared and implemented.
- Review evidence of previously detected deficiencies and determine whether corrective action was taken.

These procedures are discussed in Paragraph 11.28 of the GAS/A-133 AICPA Audit Guide.

The pass-through entity should consider whether its receipt and review of the subrecipient's OMB Circular A-133 audit is sufficient to meet the subrecipient monitoring requirement. For example, an award passed through to a subrecipient may not have been tested as a major program in the subrecipient's audit. While the pass-through entity's receipt and review of the subrecipient's OMB Circular A-133 may be sufficient, Paragraph 11.29 of the GAS/A-133 AICPA Audit Guide states that "it is more likely that the receipt and review of such audit results only is one tool used by the pass-through entity as part of a comprehensive subrecipient-monitoring process." The performance of other monitoring procedures may also be necessary.

Pass-through entities should consider the cost-effectiveness of monitoring procedures compared to the relative size and complexity of the federal awards administered by subrecipients in determining the appropriateness of monitoring procedures. For example, if the majority of a pass-through federal award is provided to two subrecipients with the remainder of the award split among six other subrecipients, the pass-through entity may decide to obtain limited scope audits or perform site visits on the first two subrecipients and only review documentation supporting requests for reimbursement from the others. If many subrecipients receive awards under the same federal program, the pass-through entity may consider rotating certain monitoring procedures through the subrecipients on a multi-year basis.

A good system of internal control by pass-through entities should include contractual provisions for appropriate sanctions when subrecipients fail to comply with program or audit requirements. Examples of appropriate sanctions are demand for refund of monies paid or refusal of subsequent funds requests.

Pass-through entities are responsible for identifying federal awards to their subrecipients and for identifying in the schedule of expenditures of federal awards the total amount provided to subrecipients under each major program. If the pass-through entity fails to advise the subrecipient that an award is federal or is unable to identify amounts provided to subrecipients, this should be considered a weakness in the pass-through entity's internal control system for monitoring subrecipients and reported as a significant deficiency (and possibly a material weakness). The auditor should also consider whether the failure is material noncompliance with the subrecipient monitoring requirement that would be required to be reported as a finding. (See Paragraph 11.36 of the GAS/A-133 AICPA Audit Guide.)

A pass-through entity has the same responsibilities for funds passed through to for-profit subrecipients as to government or nonprofit subrecipients, except that the requirements of OMB Circular A-133 do not apply to for-profit subrecipients. Since audit requirements are not specified, the monitoring procedures over for-profit subrecipients are more important. Section 210(e) of OMB Circular A-133 states that the contract with a for-profit subrecipient should describe, rather than simply reference, the applicable compliance requirements with which the for-profit subrecipient must comply.

Subrecipient Responsibilities

The subrecipient is responsible for having its federal awards audited in accordance with the requirements specified by the pass-through entity. If the subrecipient expends \$500,000 or more in federal awards during the subrecipient's fiscal year, the audit coverage at a minimum should meet the requirements of OMB Circular A-133.

For each award received, a subrecipient is required to include in the schedule of expenditures of federal awards the name of the pass-through entity and its corresponding number. Other information requested by the pass-through entity may be included in the schedule at the discretion of the subrecipient. If the pass-through entity has failed to identify the amount of federal awards included in subgrants, then the subrecipient must attempt to identify or determine the amount. If the subrecipient is unable to identify the federal awards included in the grant, then the full amount should be considered as federal awards and reported in the schedule of expenditures of federal awards with a footnote that the federal amount cannot be determined.

For audits performed in accordance with OMB Circular A-133, subrecipients are responsible for submitting a data collection form and reporting package to the federal clearinghouse and pass-through entity.

A corrective action plan, also part of the reporting package, is required by federal audit requirements for any pass-through entity or subrecipient that has a finding or questioned cost; therefore, the subrecipient should develop and implement a corrective action plan addressing audit findings and recommendations resulting from its OMB Circular A-133 audit.

In some instances, subrecipients may pass federal awards through to other organizations. In these cases, the subrecipient assumes the roles and responsibilities of a pass-through entity.

Recovery Act Considerations. Subrecipients are required to separately identify Recovery Act funds, including those expended for existing programs, on the schedule of expenditures of federal awards and the data collection form.

Auditor Responsibilities

Recovery Act Considerations. The OMB has established several new requirements for reporting Recovery Act funds, including requirements to separately identify Recovery Act, including a new requirement to report certain pass-through award information to federal agencies within 10 days after the end of each quarter, funds on the schedule of expenditures of federal awards and the data collection form. The Recovery Act also requires pass-through entities to separately identify and document Recovery Act funds passed through to subrecipients. According to Appendix VII of the 2009 Compliance Supplement, the auditor should consider the requirements regarding separately identifying Recovery Act awards "when performing procedures for the purpose of providing the in-relation-to reporting on the SEFA, as well as when performing other procedures on the SEFA in conjunction with the compliance testing."

Consideration of Subrecipient Monitoring. Auditors should consider subrecipient monitoring when the recipient passes through federal awards that are material to a major program. Paragraph 11.25 of the GAS/A-133 AICPA Audit Guide states:

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.

The auditor is required to test major program compliance with the types of compliance requirements that are material to a major program. If subrecipients are included only in nonmajor programs, the auditor has no responsibility for testing subrecipient monitoring. Subrecipient monitoring is one of the fourteen types of compliance requirements included in the *OMB Circular A-133 Compliance Supplement* (Compliance Supplement). The auditor should use professional judgment in comparing the amount of federal funds passed through to subrecipients to the major program's total expenditures. The more material the pass-through funds are to the major program, the greater the need for the auditor to test the subrecipient monitoring requirements.

Audit Objectives. The Compliance Supplement identifies several audit objectives for the auditor related to subrecipient monitoring. According to the Compliance Supplement (Part 3, Section M), 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 OMB Circular A-133, 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 administered federal awards in compliance with federal requirements,
- ensured that 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, and
- evaluated the impact of subrecipient activities on the pass-through entity.

Consideration of Internal Controls over Subrecipient Monitoring. The Compliance Supplement provides guidance on internal controls over subrecipient monitoring. It suggests that the auditor—

- a. Use the guidance in the Compliance Supplement, Part 6—Internal Control, to perform procedures to obtain an understanding of internal control sufficient to plan the audit to support a low assessed level of control risk for the program.
- b. Plan tests of internal control to support a low assessed level of control risk for subrecipient monitoring and perform the testing of internal control as planned.
- c. Consider the results of internal control testing when assessing the risk of noncompliance and determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.

The GAS/A-133 AICPA Audit Guide, Paragraph 11.23, explains that tests of internal control over subrecipient monitoring might include inquiry, observation, inspection of documentation, or reperformance by the auditor of some or all of the pass-through entity's monitoring procedures. The nature and extent of the tests performed will depend on the auditor's assessment of inherent risk, understanding of internal control over subrecipient monitoring, materiality, and professional judgment.

Part 6 of the Compliance Supplement describes numerous characteristics of internal control over compliance that, when present and operating effectively, should reasonably assure compliance with program requirements for subrecipient monitoring.

Recovery Act Considerations. Federal officials have expressed concerns about whether recipients' internal controls will be able to cope with the potentially greatly increased funding received under the Recovery Act. In GAQC Alert #106, *Effect of American Recovery and Reinvestment Act of 2009 on Single Audits*, the AICPA's Governmental Audit Quality Center suggests that auditors may want to advise pass-through entities to consider whether their controls ensure appropriate subrecipient monitoring and whether new controls are needed to meet new subrecipient reporting responsibilities.

Suggested Audit Procedures for Compliance. The Compliance Supplement provides suggested compliance audit procedures related to subrecipient monitoring and recommends using dual-purpose tests when performing audit procedures for internal control and compliance. The Compliance Supplement suggests that the pass-through entity auditor perform the following audit procedures:

- a. Gain an understanding of the pass-through entity's subrecipient procedures through a review of the pass-through entity's subrecipient monitoring policies and procedures (e.g., annual monitoring plan) and discussions with staff. This should include an understanding of the scope, frequency, and timeliness of monitoring activities and the number, size, and complexity of awards to subrecipients.
- b. Select a sample of award documents and agreements to ascertain if: (a) at the time of award the pass-through entity made subrecipients aware of the award information (e.g., CFDA title and number, amount of award, award name, name of Federal agency) and requirements imposed by laws, regulations and the provisions of contract or grant agreements; and (b) the activities approved in the award documents were allowable.
- c. Review the pass-through entity's documentation of during-the-award monitoring to ascertain if the pass-through entity's monitoring provided reasonable assurance that subrecipients used Federal awards for authorized purposes, complied with laws, regulations, and the provisions of contracts and grant agreements, and achieved performance goals.
- d. Review the pass-through entity's follow-up to ensure corrective action on deficiencies noted in during-the-award monitoring.
- e. Verify that the pass-through entity:
 - (1) Ensured that the required subrecipient audits were completed. For subrecipients that are not required to submit a copy of the reporting package to a pass-through entity because there were "no audit findings" [i.e., because the schedule of findings and questioned costs did not disclose audit findings relating to the federal awards that the pass-through entity provided and the summary schedule of prior audit findings did not report the status of audit findings relating to federal awards that the pass-through entity provided, as prescribed in OMB Circular A-133, Section 320(e)], the pass-through entity may use the information in the Federal Audit Clearinghouse (FAC) database (available on the Internet at <http://harvester.census.gov/sac>) as evidence to verify that the subrecipient had "no audit findings" and that the required audit was performed. This FAC verification would be in lieu of reviewing submissions by the subrecipient to the pass-through entity when there are no audit findings.
 - (2) Issued management decisions on audit findings within six months after receipt of the subrecipient's audit report.
 - (3) Ensured that subrecipients took appropriate and timely corrective action on all audit findings.
- f. Verify that in cases of continued inability or unwillingness of a subrecipient to have the required audits, the pass-through entity took appropriate action using sanctions.
- g. Verify that the effects of subrecipient noncompliance are properly reflected in the pass-through entity's records.

- h. Verify that the pass-through entity monitored the activities of subrecipients not subject to OMB Circular A-133, using techniques such as those discussed in the Compliance Requirements provisions of this section with the exception that these subrecipients are not required to have audits under OMB Circular A-133.

Part 3, Section M of the Compliance Supplement notes that auditors may consider coordinating the testing of subrecipient monitoring with tests related to subrecipients performed as part of the following compliance requirements:

- Cash management (tests of cash reports submitted by subrecipients) (Part 3, Section C of the Compliance Supplement).
- Eligibility (tests that subawards were made only to eligible subrecipients) (Part 3, Section E of the Compliance Supplement).
- Procurement (tests of suspension and debarment certifications) (Part 3, Section I of the Compliance Supplement).

PPC's *Single Audit Compliance Program Creator* creates a custom audit procedures checklist (compliance program) from the *OMB Circular A-133 Compliance Supplement*, tailored to specific federal programs and client characteristics. The *Single Audit Compliance Program Creator* is available through PPC's website at ppc.thomson.com and by calling (800) 323-8724.

In subrecipient audit engagements, the auditor should look for additional requirements imposed by the pass-through entity and indications that the relationship is one of a vendor rather than a subrecipient.

If the subrecipient is a for-profit organization, the pass-through entity auditor's responsibilities are similar to those for government or nonprofit subrecipients, except that the audit requirements of OMB Circular A-133 do not apply to the for-profit organization unless incorporated into the award agreement by the pass-through entity.

Recovery Act Considerations. The 2009 Compliance Supplement was not updated for the Recovery Act due to the limited time between enactment of the new law and issuance of the Compliance Supplement. However, Appendix VII to the Compliance Supplement contains important considerations for auditors about Recovery Act awards, including information about compliance requirements. Appendix VII states that auditors should:

- Review award documents, including terms and conditions.
- Check the OMB website for addenda to the Compliance Supplement.
- Use the framework provided by the Compliance Supplement (for example, in Parts 3, 4, 5, and 7) as guidance to identify material compliance requirements and determine appropriate audit procedures.

The OMB plans to periodically issue addenda to the Compliance Supplement to provide additional guidance on audits of Recovery Act awards, including unique compliance requirements.

Appendix VII specifically mentions the Reporting compliance requirement as one for which the OMB expects to provide additional guidance. Beginning with the quarter ending September 30, 2009, specific information must be reported to the federal funding agency within 10 days of the quarter end. Recipients are required to report both for themselves and for their subrecipients. It is believed that it will be necessary for the auditor to consider this reporting requirement when auditing compliance.

Inadequate Subrecipient Monitoring System. If the pass-through entity's subrecipient monitoring system is not adequate to ensure the subrecipient's compliance with laws, regulations, grants, and contracts, the auditor should report a significant deficiency (and possibly a material weakness) and consider whether the inadequacy represents a noncompliance that should be reported as a compliance finding. The scope of the pass-through entity's audit may be expanded to include testing the subrecipients' compliance. This testing may establish subrecipient compliance with certain types of compliance requirement (i.e., eligibility). Paragraph 11.34 of the GAS/A-133 AICPA Audit Guide indicates that such an expansion of the scope of the audit would not be sufficient to remedy the control

deficiency and, if applicable, noncompliance of the pass-through entity's monitoring system. However, Paragraph 11.34 does indicate that noncompliance for the type of compliance requirement being tested (i.e., eligibility) may be resolved by the expanded procedures.

If the subrecipient monitoring system is inadequate, the auditor should consider whether the inadequacy affects the opinion on the financial statements and whether to report a finding in the Yellow Book report. The GAS/A-133 AICPA Audit Guide, Paragraph 11.35, states that in this situation, if amounts passed through to subrecipients are material to the pass-through entity's financial statements, the auditor may need to modify the report on the financial statements. Before making this determination, the auditor should consider whether other available audit evidence (such as subrecipients' audit reports and other financial reports that had been submitted to the pass-through entity) indicates that the subrecipient administered the program in compliance with laws and regulations.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Which of the following responsibilities is required of a pass-through entity?
- a. Keep submitted financial reports of subrecipients for a minimum of five years from the date of submission.
 - b. Make certain subrecipients receiving \$300,000 or more annually in federal awards meet Circular A-133 audit requirements.
 - c. Examine the subrecipient's activities to ensure authorized use of award and achievement of performance goals.
 - d. Inform subrecipients receiving \$500,000 or more annually in federal awards of CFDA title and number, as well as award name and number.
22. What may pass-through entities do?
- a. Audit all subrecipients on a rotational basis.
 - b. Send a questionnaire to subrecipients to determine total federal funds expended.
 - c. Not monitor the activities of subrecipients to ensure compliance.
 - d. Contact the OMB A-133 auditing firm directly to discuss subrecipient deficiencies.
23. With respect to subrecipient monitoring activities, which of the following activities would **not** be appropriate?
- a. Reviewing financial and performance reports submitted in subrecipient's periodic reporting packages.
 - b. Visiting the subrecipient's operating location to review financial and records and observe operations.
 - c. Routine contacts with and inquiries of subrecipient personnel regarding their program activities.
 - d. Requiring subrecipients to pay for semi-annual audits when the subrecipient is already subject to the annual single audit.
24. What should pass-through entities consider?
- a. If monitoring procedures for each federal award is equal in cost.
 - b. If additional monitoring is necessary after review of required OMB Circular-133 audit.
 - c. If for-profit subrecipients require an audit under OMB Circular A-133.
 - d. If quality control reviews of subrecipient audits by the federal cognizant agencies are required.
25. As pass-through funds become more material to the major program, the need for the auditor to test the subrecipient monitoring requirements:
- a. Increases.
 - b. Decreases.
 - c. Stays the same.
 - d. Varies with the experience of the auditor.

26. Which audit procedure listed below is **not** suggested for the pass-through entity's auditor in the Compliance Supplement?
- a. Review the annual subrecipient monitoring program.
 - b. Review staffing levels of the subrecipient.
 - c. Review the pass-through entity's follow-up actions to determine whether corrective action and/or sanctions were imposed on the subrecipient in the event of non-compliance.
 - d. Determine whether the pass-through entity issued management decisions on audit findings and ensured that subrecipients took appropriate and corrective action on audit findings.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Which of the following responsibilities is required of a pass-through entity? **(Page 56)**

- a. Keep submitted financial reports of subrecipients for a minimum of five years from the date of submission. [This answer is incorrect. Although pass-through entities must maintain submitted reports, the requirement is a minimum of *three* years *not five* from the date of submission.]
- b. Make certain subrecipients receiving \$300,000 or more annually in federal awards meet Circular A-133 audit requirements. [This answer is incorrect. Pass-through entities must ensure the audits of subrecipients receiving *\$500,000* or more annually in federal awards.]
- c. **Examine the subrecipient's activities to ensure authorized use of award and achievement of performance goals. [This answer is correct. The pass-through entity must ensure compliance of the subrecipient, as well as advise them of requirements imposed on them by federal laws and regulations.]**
- d. Inform subrecipients receiving \$500,000 or more annually in federal awards of CFDA title and number, as well as award name and number. [This answer is incorrect. This requirement is necessary for *all* subrecipients. In addition, informing them of the name of the federal agency and whether the award is R&D if required. If any of this information is not available, the pass-through entity should describe the federal award using the best information available.]

22. What may pass-through entities do? **(Page 57)**

- a. Audit all subrecipients on a rotational basis. [This answer is incorrect. Even if the subrecipient meets the threshold for an OMB audit, the pass-through entity is not responsible for conducting it.]
- b. **Send a questionnaire to subrecipients to determine total federal funds expended. [This answer is correct. As part of the monitoring process, the pass-through entity may send a questionnaire to subrecipients to determine total federal funds expended.]**
- c. Not monitor the activities of subrecipients to ensure compliance. [This answer is incorrect. Pass-through entities are required to monitor subrecipients to ensure compliance.]
- d. Contact the OMB A-133 auditing firm directly to discuss subrecipient deficiencies. [This answer is incorrect. A pass-through entity would not normally contact a subrecipient's accounting firm.]

23. With respect to subrecipient monitoring activities, which of the following activities would **not** be appropriate? **(Page 57)**

- a. Reviewing financial and performance reports submitted in subrecipient's periodic reporting packages. [This answer is incorrect. This is a normal monitoring activity that would occur throughout the year.]
- b. Visiting the subrecipient's operating location to review financial and records and observe operations. [This answer is incorrect. This is a recommended monitoring activity that should be performed by the pass-through entity. The larger the percentage of program awards passed through, the greater the need for this and other types of monitoring becomes.]
- c. Routine contacts with and inquiries of subrecipient personnel regarding their program activities. [This answer is incorrect. The Compliance Supplement that monitors activities such as this one should occur normally throughout the year. It is important to note that larger dollar awards are of greater risk and would require this and other monitoring activities to be used to check for compliance.]

- d. **Requiring subrecipients to pay for semi-annual audits when the subrecipient is already subject to the annual single audit. [This answer is correct. Requiring subrecipients to pay for semi-annual audits for grants received that exceed a threshold established by the pass-through entity would not be encouraged since the audit requirement threshold under OMB A-133 would apply if the threshold has been met and monitoring activities are used to ensure compliance for those not meeting the OMB A-133 audit threshold. However, charges for limited scope audits are not prohibited provided the subrecipient is not required to have a single audit.]**

24. What should pass-through entities consider? **(Page 59)**

- a. If monitoring procedures for each federal award is equal in cost. [This answer is incorrect. Cost-effectiveness of monitoring procedures compared to size of federal awards should be considered. It is appropriate to spend more time and resources on larger or more complex federal awards.]
- b. **If additional monitoring is necessary after review of required OMB Circular-133 audit. [This answer is correct. The receipt and review of the audit results is only one tool used as part of a comprehensive subrecipient-monitoring process. Other monitoring procedures may also be necessary.]**
- c. If for-profit subrecipients require an audit under OMB Circular A-133. [This answer is incorrect. The pass-through entity would not have to consider this because the requirements of Circular A-133 do not apply to for-profits. However, a pass-through entity has the same responsibilities for the funds passed through to them; and therefore, the monitoring procedures are more important.]
- d. If quality control reviews of subrecipient audits by the federal cognizant agencies are required. [This answer is incorrect. These quality-control reviews are never required by the circular. However, pass-through entities are expected to ensure that audits of their subrecipients meet the requirements of OMB Circular A-133 by establishing a system that includes an initial review of each subrecipient report.]

25. As pass-through funds become more material to the major program, the need for the auditor to test the subrecipient monitoring requirements: **(Page 61)**

- a. **Increases. [This answer is correct. There is a greater need to test the subrecipient monitoring requirements when the pass-through funds are more material to the major program.]**
- b. Decreases. [This answer is incorrect. As funds become more significant, the need to test does not decrease.]
- c. Stays the same. [This answer is incorrect. As funds become more significant, the need to test changes.]
- d. Varies with the experience of the auditor. [This answer is incorrect. As the experience of the auditor increases, testing becomes efficient.]

26. Which audit procedure listed below is **not** suggested for the pass-through entity's auditor in the Compliance Supplement? **(Page 62)**

- a. Review the annual subrecipient monitoring program [This answer is incorrect. This is a suggested audit procedure, the auditor should review the annual subrecipient monitoring program.]
- b. **Review staffing levels of the subrecipient. [This answer is correct. This is not a suggested audit procedure and therefore is the correct answer to this question. The auditor would not ordinarily review staffing levels of a subrecipient during a pass-through entity's audit.]**
- c. Review the pass-through entity's follow-up actions to determine whether corrective action and/or sanctions were imposed on the subrecipient in the event of non-compliance. [This answer is incorrect. This is a suggested audit procedure and therefore not the exception to the question. The auditor should review the pass-through entity's follow-up actions to determine whether corrective action and/or sanctions were imposed on the subrecipient in the event of non-compliance.]

- d. Determine whether the pass-through entity issued management decisions on audit findings and ensured that subrecipients took appropriate and corrective action on audit findings. [This answer is incorrect. This is a suggested audit procedure. The auditor should ensure that the pass-through entity issued management decisions on audit findings and took corrective action, including sanctions for non-compliance.]

AUDIT REQUIREMENTS

Pass-through Entities

Pass-through entities are subject to the same audit requirements under OMB Circular A-133 as primary recipients. However, the determination of when a federal award is expended may differ. For primary recipients, an award is expended when the funds are disbursed to purchase goods or services. For a pass-through entity, an award is expended when it is disbursed to the subrecipient, not when the subrecipient ultimately expends the funds. Thus, the amount of federal awards passed through to subrecipients must be included in the pass-through entity's total federal awards expended. This means that amounts provided to subrecipients should be included in the schedule of expenditures of federal awards and in the pass-through entity's determination of major programs.

The pass-through entity's auditor is not responsible for auditing the subrecipients. However, subrecipient monitoring is one of the 14 types of compliance requirements included in the Compliance Supplement. Therefore, if material payments to subrecipients are included in any of the entity's major programs, the auditor must review the entity's system for monitoring subrecipients and obtaining and acting on subrecipient audit reports.

The audit report of the subrecipient need not cover the same period as the pass-through entity's audit report, if the subrecipient's report is current. However, if a subrecipient's audit report was due, but not received, the pass-through entity's auditor should report this as a finding.

The auditor should also consider if reported instances of subrecipient noncompliance, significant deficiencies, and/or material weaknesses in the pass-through entity's monitoring system could have a material effect on its major federal awards programs or its financial statements. If necessary, such conditions or the failure of a subrecipient to have a required audit should be included in the schedule of findings and questioned costs. Also, these conditions might cause the auditor to modify the compliance report on the pass-through entity.

In certain circumstances, subrecipient noncompliance (including inadequate internal controls) or inadequacies in the pass-through entity's monitoring system could affect the opinion on the financial statements. For example, if a significant portion of a pass-through entity's funding is from federal sources, and much of the federal awards are passed through to one or more subrecipient, the opinion on the financial statements may need to be qualified (or worse) if the auditor concludes that the pass-through entity's monitoring system is inadequate or there is material noncompliance by a subrecipient. Whether such noncompliance by the pass-through entity or subrecipients affects the report on major programs and/or the report on the financial statements is dependent on a number of factors, including the nature of the program, the funding level (to the pass-through entity and subrecipients), and the type of noncompliance (e.g., known questioned costs, internal control inadequacies, monitoring failures, etc.).

Government and Nonprofit Subrecipients

Subrecipients are subject to the requirements specified by OMB Circular A-133 and each pass-through entity. A state or local government or nonprofit organization may have its own audit requirements in addition to those for OMB Circular A-133 audits of subrecipients. These additional audit requirements may be passed down to the subrecipient provided the audit covers the federal requirements as a minimum.

It is the subrecipient's responsibility to learn or determine the amount, if any, of federal awards included in monies received from a pass-through entity when the information is not provided by the pass-through entity. If the pass-through entity is not able to determine the portion of federal awards included in the monies received, the auditor, at a minimum, should review the award documents and determine if the terms and conditions of the awards are being met for all funds. The auditor should comment in the audit report that federal awards could not be identified in pass-through awards and recommend that the pass-through entity identify the amount of federal awards in subawards.

The internal auditor of a governmental pass-through entity may be considered independent under the definition of an independent auditor included in the Single Audit Act Amendments of 1996 and thus able to conduct an OMB Circular A-133 audit of a subrecipient if it is agreeable to the subrecipient and the internal auditor also meets applicable Yellow Book independence requirements. That option, however, is not available to nonprofit pass-

through entities because internal auditors of a nonprofit organization are not included in the definition of an independent auditor. That does not, however, prevent nonprofit internal auditors from performing other monitoring functions such as limited scope engagements. In order to conduct an OMB Circular A-133 audit of a subrecipient, the internal auditor also must meet the independence requirements of the Yellow Book.

The Mid-America Intergovernmental Audit Forum has developed *A Guide for Roles and Responsibilities in Subrecipient Audits*. Though the guide was developed before the issuance of the 1997 edition of OMB Circular A-133 and certain specific information may no longer be applicable, it is believed to continue to provide good general guidance. A copy may be downloaded from the GAO website at www.gao.gov.

Foreign Subrecipients

Paragraph 4 of OMB Circular A-133 states that it does not apply to non-U.S. based entities expending federal awards received either directly as a recipient or indirectly as a subrecipient. However, the exclusion of non-U.S. based entities from OMB Circular A-133 does not relieve the pass-through entity of its compliance requirements. Paragraph 11.41 of the GAS/A-133 AICPA Audit Guide states that the pass-through entity and its auditor have the same responsibilities as if the foreign subrecipient was a for-profit subrecipient.

For-profit Subrecipients

The Single Audit Act Amendments of 1996 and OMB Circular A-133 contain no audit requirements for for-profit organizations or individuals. A pass-through entity, however, has the same responsibilities for awards passed through to for-profit subrecipients as for nonprofit or governmental subrecipients, except that Circular A-133 does not establish subrecipient audit requirements for the for-profit organization.

As discussed in OMB Circular A-133, Section 210(e), and Paragraph 11.40 of the GAS/A-133 AICPA Audit Guide, since OMB 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. The contract with the for-profit subrecipient should include applicable compliance requirements. 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. Also, the pass-through entity should consider establishing appropriate audit requirements of its own and include them in contracts with its for-profit subrecipients. OMB Circular A-110, Subpart C, Paragraph .26(d), states “commercial organizations shall be subject to the audit requirements of the Federal awarding agency or the prime recipient as *incorporated into the award document* [emphasis added].” However, the same restrictions on allowable audit costs for governmental or nonprofit subrecipients applies to for-profit subrecipients. Only the costs of limited scope engagements and other monitoring procedures that meet the criteria discussed previously in this lesson may be charged as a direct cost to the program.

When a pass-through entity passes down federal awards to a profit-making subrecipient, the pass-through entity generally has the same responsibilities as those for a governmental or nonprofit subrecipient, including to:

- a. 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.
- b. 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.
- c. 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.
- d. Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.
- e. 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 Circular A-133.

The only responsibilities of a pass-through entity that would not apply to a for-profit subrecipient are those related to the identification of federal award information for the schedule of expenditures of federal awards and those ensuring that an audit was performed under OMB Circular A-133 when the subrecipient expended \$500,000 or more in federal awards during the subrecipient's fiscal year.

As with governmental and nonprofit subrecipients, the auditor's responsibility is not to audit the subrecipients but to test and evaluate the pass-through entity's system for monitoring its subrecipients.

Vendors

Payments for goods or services provided by a vendor are not considered federal awards under OMB Circular A-133. As a result, the audit requirement under OMB Circular A-133 does not apply to vendors whether they are governmental, nonprofit, or for-profit entities. However, the auditee is responsible for ensuring that the purchase of goods or services complies with the appropriate laws, regulations, contracts, and grant agreements. While federal program compliance requirements normally do not pass through to vendors, if a vendor is responsible for ensuring some part of the federal program compliance then the auditee must review the vendor's transactions or records to ensure program compliance. Vendor compliance considerations are discussed in Paragraphs 11.15–11.17 of the GAS/A-133 AICPA Audit Guide.

The auditor's responsibility for payments to vendors is limited to determining that material payments to vendors under major federal awards programs are in compliance with laws, regulations, and the provisions of contracts or grant agreements. When vendors are responsible for program compliance, the auditor should determine that the vendor's transactions are also in compliance with laws, regulations, and the provision of contracts or grant agreements. This determination normally would be accomplished by first reviewing the auditee's records and the results of the auditee's own review procedures for vendor program compliance. If the auditee's records and review procedures are not sufficient to determine vendor compliance, Paragraph 11.16 of the GAS/A-133 AICPA Audit Guide indicates that the auditor "also should perform additional procedures to determine compliance." This may include testing the vendor's transactions directly or obtaining reports on compliance procedures performed by the vendor's independent auditor. The auditor must also evaluate the deficiency in the auditee's records and review procedures and consider whether it is a significant deficiency or material weakness.

LIMITED SCOPE ENGAGEMENTS

Introduction

OMB Circular A-133 identifies limited scope engagements of specific compliance areas as one of the tools that pass-through entities may use to monitor subrecipients. The Compliance Supplement also identifies agreed-upon procedures engagements as tools for monitoring certain aspects of subrecipient activities. Section 230(b)(2) of OMB Circular A-133 indicates that limited scope audits are agreed-upon procedures engagements conducted in accordance with the AICPA's auditing or attestation standards. To encourage pass-through entities to choose the limited scope audit over more expensive audit procedures, OMB Circular A-133 permits a pass-through entity to charge the cost of the limited scope audit to its federal award if the subrecipient is not required to have a single audit.

Agreed-upon procedures engagements must be paid for and arranged by the pass-through entity, *not* the subrecipient. This is because the agreed-upon procedures engagement is being performed on behalf and for the benefit of the pass-through entity as part of its required subrecipient monitoring process. In addition, OMB Circular A-133 limits agreed-upon procedures engagements to those addressing the following five types of compliance requirements:

- Activities allowed or unallowed.
- Allowable costs/cost principles.
- Eligibility.
- Matching, level of effort, earmarking.

- Reporting.

Charges for agreed-upon procedures engagements that address any other type of compliance requirement or that are arranged by the subrecipient currently cannot be paid from federal awards. A representative of OMB has publicly stated that if a pass-through entity contracts for an agreed-upon procedures engagement as permitted by OMB Circular A-133 that tests both federal and state laws, regulations, contracts, and agreements, a pro-rata share of the total cost of the engagement can be paid from federal awards.

As previously mentioned, OMB specifically identifies agreed-upon procedures engagements as the only type of limited scope audit that pass-through entities may use for monitoring subrecipients. An agreed-upon procedures engagement is one in which a practitioner is engaged by a client to perform specific procedures and report findings. The practitioner does not perform an audit or provide an opinion or any other form of assurance on the information. (Practitioners are prohibited from providing negative assurance in connection with an agreed-upon procedures engagement.) Rather, he or she performs only those procedures that have been agreed to with the client and reports the findings.

Standards for Agreed-upon Procedures Engagements

All agreed-upon procedures engagements relating to subrecipient monitoring must be conducted in accordance with the AICPA's attestation standards. SSAE No. 10, *Attestation Standards: Revision and Recodification*, as amended, requires all engagements to apply agreed-upon procedures, including those related to subrecipient monitoring.

Deciding between AT 201 and AT 601 of SSAE No. 10. A common question that arises when the engagement will be performed as an agreed-upon procedures engagement is which section of the attestation standards applies? Depending on the nature of the engagement, auditors must choose from one of the following:

- SSAE No. 10 (AT 601, *Compliance Attestation*). AT 601 applies when a practitioner is engaged to perform agreed-upon procedures and report on compliance with laws, regulations, or contractual provisions. Thus, an engagement to perform specific procedures to a subrecipient's assertion about compliance with specific provisions of a grant agreement between the subrecipient and a pass-through entity generally could be performed under AT 601.
- SSAE No. 10 (AT 201, *Agreed-Upon Procedures Engagements*). AT 201 applies to all other agreed-upon procedures engagements. In some cases, an engagement to report on compliance would be performed under AT 201 instead of AT 601. For instance, if there is no grant agreement or other contract between a subrecipient and the pass-through entity, the engagement would be performed under AT 201. It is expected that the situation where there is no grant agreement or other contract will be rare as there should always be a grant or other contractual agreement. Thus, lack of a grant agreement or contract will seldom be the determining factor when deciding whether to perform an agreed-upon procedures engagement under AT 201 or AT 601.

The following paragraphs provide an overview of the engagement acceptance considerations that apply to all such agreed-upon procedures engagements as well as issues related to obtaining written assertions. [*PPC's Guide to Nontraditional Engagements* provides detailed guidance on performing and reporting on agreed-upon procedures engagements performed under AT 201 and AT 601. Call (800) 323-8724 for order information, or order online at ppc.thomson.com.]

Conditions for Engagement Acceptance

Several conditions exist whenever a practitioner performs an agreed-upon procedures engagement. To ensure that a practitioner does not accept an engagement that he or she is unable to perform, the following conditions generally should be met before accepting an agreed-upon procedures engagement:

- a. The practitioner obtains evidence of the responsible party's (for example, the subrecipient) responsibility for the subject matter. (If the engagement is to be performed under AT 601, *Compliance Attestation*, the responsible party is also required to (1) accept responsibility for the entity's compliance with the grant

agreement or contract's requirements and the effectiveness of internal controls over compliance and (2) evaluate the entity's compliance with the specified requirements or the effectiveness of internal controls over compliance.)

b. The practitioner:

- (1) Is independent (under the independence rules of both the AICPA and *Government Auditing Standards*).
- (2) Believes the subject matter to which the procedures are to be applied is subject to reasonably consistent measurement.
- (3) Expects that the procedures to be performed will result in reasonably consistent findings.
- (4) Expects that evidential matter related to the subject matter exists to provide a reasonable basis for findings.
- (5) Considers (a) what services are to be provided and whether professional standards or other relevant requirements can be met in providing those services and (b) whether there are any professional reasons not to provide the requested services.
- (6) Considers the integrity of the prospective client and its management.

c. The practitioner and specified parties agree on:

- (1) The procedures performed or to be performed.
- (2) The criteria to be used in determining findings.
- (3) Materiality limits for reporting purposes, when applicable.

d. The specified parties:

- (1) Take responsibility for the sufficiency of the procedures for their purposes.
- (2) Understand and accept that the use of the report will be restricted to their own use.

Written Assertions

According to AT 201, an assertion is any declaration or set of related declarations about whether the subject matter is based on or in conformity with the criteria selected.

Is a Written Assertion Necessary? AT 201, *Agreed-Upon Procedures Engagements*, does not require practitioners to obtain a written assertion in an agreed-upon procedures engagement. Thus, practitioners are not required to obtain a written assertion in an agreed-upon procedures engagement unless specifically required by another attestation standard that applies to the particular type of agreed-upon procedures engagement being performed. For instance, AT 601, *Compliance Attestation*, requires practitioners to obtain a written assertion in an engagement to apply procedures to support a responsible party's assertion relative to compliance with the terms of a grant agreement or contract.

Obtaining a Written Assertion. The written assertion should come from the responsible party. If, for example, the practitioner is asked to perform procedures to determine the subrecipient's compliance with specific compliance requirements established in the grant agreement, the written assertion will need to come from the subrecipient. Since subrecipients are probably expending grant funds under the terms of grant agreements, they should be willing to provide written statements stating that they have complied with their agreements. A simple statement (for example, a letter) that the terms of the agreement with the client (the pass-through entity) have been complied with should be sufficient. Such representations also can be obtained in a representation letter.

For example, a written assertion in a subrecipient monitoring engagement might be a representation by a subrecipient that the subrecipient has complied with the eligibility compliance requirement in the XYZ grant agreement for the year ended June 30, 20X1.

Overview of a Subrecipient Monitoring Agreed-upon Procedures Engagements

As previously noted, most agree that agreed-upon procedures for most subrecipient monitoring engagements will be performed under AT 601. Regardless of which standards apply, most believe that practitioners will perform the following procedures in most agreed-upon procedures engagements:

- a. Establish an understanding with the client, including obtaining an engagement letter.
- b. Obtain an understanding of the subject matter (or the related assertion).
- c. Design the procedures to be performed.
- d. Perform the procedures.
- e. Obtain a letter of representations. (Only AT 601 *requires* a representation letter.)
- f. Prepare a summary of findings (a report).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. Which of the following examples of subrecipient noncompliance would **not** potentially affect the opinion on the pass-through entities financial statements?
- a. Immaterial questioned costs.
 - b. Internal control weaknesses.
 - c. Inadequate subrecipient monitoring system.
 - d. A subrecipient's failure to file required reports to pass-through entity.
28. Which of the following is correct concerning limited scope engagements of specific compliance areas?
- a. This type of engagement is the only tool for a pass-through entity to use to monitor subrecipients.
 - b. Limited scope audits are agreed-upon procedures engagements conducted in accordance with the AICPA's auditing or attestation standards.
 - c. A pass-through entity is not permitted to charge the cost of the limited scope audit to its federal award.
 - d. The practitioner performs an audit and provides an opinion in connection with an agreed-upon procedures engagement.
29. Who should the auditor get the written assurance from?
- a. The responsible party.
 - b. The pass-through entity.
 - c. The subrecipient.
 - d. The client of an agreed-upon procedures engagement.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. Which of the following examples of subrecipient noncompliance would **not** potentially affect the opinion on the pass-through entities financial statements? **(Page 70)**
- a. **Immaterial questioned costs. [This answer is correct. Because the questioned costs were immaterial, they would not adversely affect the opinion.]**
 - b. Internal control weaknesses. [This answer is incorrect. Internal control weaknesses can potentially affect the opinion on the financial statements.]
 - c. Inadequate subrecipient monitoring system. [This answer is incorrect. An inadequate monitoring system can potentially affect the opinion on the financial statements.]
 - d. A subrecipient's failure to file required reports to pass-through entity. [This answer is incorrect. A subrecipient's failure to file required reports can potentially affect the opinion on the financial statements.]
28. Which of the following is correct concerning limited scope engagements of specific compliance areas? **(Page 72)**
- a. This type of engagement is the only tool for a pass-through entity to use to monitor subrecipients. [This answer is incorrect. This is one of the tools that can be used. However, agreed-upon procedures engagements are the only type of limited scope audit that pass-through entities may use for monitoring subrecipients.]
 - b. **Limited scope audits are agreed-upon procedures engagements conducted in accordance with the AICPA's auditing or attestation standards. [This answer is correct. In fact, all agreed-upon procedures engagements are performed under the attestation standards.]**
 - c. A pass-through entity is not permitted to charge the cost of the limited scope audit to its federal award. [This answer is incorrect. They are permitted to charge the cost to the federal award as long as the subrecipient is not required to have a single audit. The pass-through entity must arrange for and pay for any agreed-upon procedure engagement, not the subrecipient.]
 - d. The practitioner performs an audit and provides an opinion in connection with an agreed-upon procedures engagement. [This answer is incorrect. There is no audit or opinion or any other form of assurance connected to an agreed-upon procedures engagement. Only those procedures that have been agreed to with the client are performed, and findings only are reported.]
29. Who should the auditor get the written assurance from? **(Page 74)**
- a. **The responsible party. [This answer is correct. The written assertion must always come from the responsible party. The assertion can be a simple statement such as a letter. It can be obtained in a representation letter. The responsible party can be the subrecipient at times or the pass-through entity.]**
 - b. The pass-through entity. [This answer is incorrect. Although the written assertion *might* at times come from the pass-through entity, this is not always the case and is not the best answer choice.]
 - c. The subrecipient. [This answer is incorrect. Although the written assertion *might* at times come from the subrecipient, this is not always the case and is not the best answer choice.]
 - d. The client of an agreed-upon procedures engagement. [This answer is incorrect. A written assertion is not required in an agreed-upon procedures engagement per AT 201.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (GSATG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

17. Federal funds awarded to a recipient are often times subsequently awarded to other governmental or nonprofit organizations. According to OMB Circular A-133, what is the entity ultimately receiving these awards known as?
- a. Subgrantor.
 - b. Subawarder.
 - c. Pass-through entity.
 - d. Subrecipient.
18. What are subrecipients, according to OMB Circular A-133?
- a. Nonfederal entities that receive federal funds from a pass through entity to carry out federal programs.
 - b. Vendors set up to carry out federal programs.
 - c. Entities barred from receiving federal funds from other sources.
 - d. Individuals that receive federal funds from federal programs.
19. What is correct concerning the common rule?
- a. The common rule applies to nonprofit organizations.
 - b. The common rule does *not* apply to governmental entities.
 - c. The common rule directs local government grantees to pass through all of the rules' provisions to their governmental subrecipients.
 - d. The common rule provides federal entities flexibility in making subgrants to other government entities.
20. Which of the following would be an indicator that an agreement might be a procurement contract?
- a. Competitive basis.
 - b. Cost sharing or participation.
 - c. Allowable costs.
 - d. Terms and conditions for grantees.
21. What must a pass-through entity do?
- a. Perform an annual audit of each subrecipient.
 - b. Advise subrecipients of compliance details required by laws, regulations, or contract or grant agreements.
 - c. Contact accounting firms providing single audit services to subrecipients to obtain key reports.
 - d. Send a questionnaire to subrecipients to determine total federal funds expended.

22. For subrecipients, the threshold for an OMB Circular A-133 audit applies to whom?
- a. To all federal and state funds expended, not just those provided by a single pass-through entity.
 - b. To all federal funds expended, not just those provided by a single pass-through entity.
 - c. To all federal and state funds provided from a single pass-through entity.
 - d. To all federal funds provided from a single pass-through entity.
23. What is a factor that may affect the nature, timing, and extent of the pass-through entity's monitoring of a subrecipient?
- a. Number of employees of subrecipient.
 - b. Relative size of contractors involved in performance of duties.
 - c. Complexity of program compliance.
 - d. The number of individuals that the subrecipient serves with the award.
24. What is included in acceptable subrecipient monitoring activities?
- a. Regular audits.
 - b. Visiting the subrecipients' operating location.
 - c. Required interviews of individuals receiving services from subrecipient.
 - d. Required interviews of subrecipient employees.
25. Which of the following procedures would **not** be recommended for a pass-through entity's subrecipient monitoring system?
- a. Reviews of subcontractor employees in the accomplishment of program objectives.
 - b. Determining whether refunds due from subrecipients are billed and collected on a timely basis.
 - c. Review and evaluate subrecipient audit reports and evaluate for completeness and for compliance with laws, regulations, contracts, and agreements.
 - d. Review whether periodic reports are received in a timely manner and investigate unusual items.
26. When planning subrecipient monitoring programs, what should pass-through entities consider?
- a. Ensuring employees use all vacation to ensure adequate reviews of all functional areas.
 - b. Appropriate sanctions for compliance failure.
 - c. Grant reporting change requests by subrecipients.
 - d. Ensuring background checks for key employees.

27. The Compliance Supplement to OMB Circular A-133 states that the auditor's responsibility regarding subrecipient monitoring is to determine whether the pass-through entity properly:
- identified federal award information and compliance requirements to the subrecipient.
 - approved personnel change requests properly.
 - monitored the pass-through entity's activities to provide reasonable assurance that the pass-through entity complied with federal requirements.
 - used appropriate contractual sanctions in a timely manner to encourage non-compliance by the subrecipient.
28. Which of the following is required for an internal auditor of a governmental pass-through entity to conduct an OMB Circular audit on a subrecipient?
- Only if it is agreeable to the subrecipient.
 - Only if the auditor meets Yellow Book independence requirements.
 - Only if the auditor works for a nonprofit pass-through entity.
 - If the auditor meets Yellow Book independence requirements and it is agreeable to the subrecipient.
29. Which of the following is correct regarding vendors and OMB A-133?
- Vendors are also referred to as subrecipients.
 - Auditees are not responsible for ensuring compliance for vendor transactions.
 - Pass-through entities award funds to vendors.
 - Vendors are not subject to annual audits.
30. Who pays for the agreed-upon procedures engagement?
- A pro-rata share from the federal award if the pass-through entity contracts for the engagement and tests both federal and state laws, regulations, contracts, and agreements.
 - 100% from the federal award as long as the subrecipient arranged the agreed-upon procedures engagement.
 - 100% from the federal award as long as the engagement addresses any type of compliance requirement other than the five listed types in OMB Circular A-133.
 - The subrecipient because the agreed-upon procedures engagement is concerned with testing compliance of the subrecipient.
31. Which condition listed below generally must **not** have to be met before accepting an agreed-upon procedures engagement?
- Independence of practitioner under the rules of the AICPA and *Government Auditing Standards*.
 - Agreement between practitioner and specified parties of procedures to be performed and criteria to be used in determining findings.
 - Understanding and acceptance between the specified parties that the report will be available for public inspection.
 - Expectation of reasonably consistent findings to result from the procedures that will be performed.

Lesson 3: Program-specific Audits

INTRODUCTION

OMB Circular A-133 at Section 105 defines a program-specific audit as an audit of one federal program as provided for in Sections 200(c) and 235 of the Circular. By comparison, a single audit is an entity-wide audit that includes one or more federal awards and the entity's financial statements. Both types of audits are used by recipients of federal awards to meet the audit requirement of OMB Circular A-133, with the program-specific election being available in only certain instances.

Historically, comparatively few program-specific audits have been performed as compared to single audits, even when the auditee met the requirements for electing a program-specific audit. This was primarily due to the small amount of guidance that had been issued concerning the responsibilities of entities making that election and their auditors. However, OMB Circular A-133 provides expanded guidance on program-specific audits.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the audit requirements for a program-specific audit.
- List and describe the reporting requirements for the entity and the auditor.

Authoritative Literature

Guidance regarding program-specific audits is primarily contained in the following documents:

- SAS No. 74 (AU 801), *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*.
- AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide).
- OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.
- OMB Circular A-133 *Compliance Supplement* (Compliance Supplement).

When Are Program-specific Audits Allowed?

Section 200(a) of OMB Circular A-133 requires that a single audit or a program-specific audit be performed on entities that expend \$500,000 or more annually in federal awards. A program-specific audit, rather than a single audit, may be elected by entities meeting both of the following criteria:

- a. Federal awards are expended under only one program (excluding research and development).
- b. The federal program's laws, regulations, or grant agreements do not require a financial statement audit.

Program Identification. Experience shows most federal awards are assigned a CFDA number so that an individual program is readily identifiable. A program for this purpose includes (a) all awards assigned a single *Catalog of Federal Domestic Assistance* (CFDA) number, (b) awards provided by the same agency for the same purpose if CFDA numbers are not assigned, and (c) awards defined as a "cluster of programs." A *cluster of programs* is defined at Section 105 of OMB Circular A-133 as a grouping of closely related programs sharing common compliance requirements that are treated as one program for determining major programs and, with the exception of research and development, whether a program-specific audit may be elected. The types of program clusters include research and development (R&D), student financial aid, and other clusters as defined by the Compliance Supplement or a state pass-through agency. If awards are expended under more than one program, the entity cannot elect to have a program-specific audit even if the awards are predominately expended under only one of the programs. In that case, if the single audit expenditure threshold is met, a single audit would have to be performed.

Financial Statement Audit. In order to elect a program-specific audit, an entity must not only expend awards under only one program, the federal program's laws, regulations, or grant agreements must not require a financial statement audit. Thus, as noted at Paragraph 13.02 of the GAS/A-133 AICPA Audit Guide, if awards are expended under only one program, the auditor should determine whether there is a financial statement audit requirement before electing to perform a program-specific audit. Footnote 1 of Paragraph 13.02 indicates that a nonprofit college that receives only student financial assistance (SFA) is an example of a situation where a program-specific audit would not be allowed even though awards are received under only one program. The reason "is because the Higher Education Act of 1965, as amended, requires institutions that receive SFA to undergo an annual financial statement audit." Thus, the financial statement audit requirement is expected to eliminate many of the single award program situations from being eligible for a program-specific audit. In addition, if a federal program law, regulation, contract or grant agreement requires a single audit, a program-specific audit may not be elected (since a single audit includes a financial statement audit requirement) and a single audit would be required.

Research and Development Award Audits. A program-specific audit is often not acceptable for multiple awards within the R&D program cluster because R&D funds can be received from many federal agencies and often involves multiple offices and accounting systems within the organization. Section 200(c) of OMB Circular A-133 indicates that a program-specific audit may be elected for the R&D program cluster only when both of the following conditions are met:

- a. There are only R&D awards and all awards are received from the same federal agency (or the same federal agency and the same pass-through entity).
- b. The applicable federal agency (or pass-through entity, in the case of a subrecipient) approves the program-specific audit in advance.

Required Program-specific Audits. Program-specific audits may be required in some instances. These audits may include federal programs received by entities not covered by OMB Circular A-133 when such an audit is required by terms of the agreement. Although unusual, such audits may also be required by a grantor agency. OMB Circular A-133 does not limit federal agencies or the Government Accountability Office from performing or arranging for additional audits or reviews. It does, however, require that the additional audits be funded by the requesting agency and build upon work, if any, performed by other auditors.

Audit Period. A definition of the audit period for a program-specific audit is not provided in OMB Circular A-133. It is believed the audit period would generally be either the fiscal period (annual or biennial) of the entity being audited or the program or award period. If a period other than the fiscal period of the entity is to be used, it is suggested the period be discussed with the federal or pass-through agency until further guidance is made available.

Program-specific Audits of For-profit Enterprises. OMB Circular A-133 does not require audits of for-profit organizations. However, where a grantee has passed through funds to a for-profit subrecipient, the primary recipient must ensure compliance with applicable laws and regulations. Paragraph 84 of the AICPA Audit Risk Alert, *Government Auditing Standards and Circular A-133 Audits—2006* noted that even though OMB Circular A-133 does not apply to for-profit recipients, the terms of the federal award may still subject the award to the requirements of OMB Circular A-133. For example, the National Institutes of Health (NIH) explicitly permits auditors to perform a program-specific audit under OMB Circular A-133 for certain of its programs. When auditing for-profit enterprises that are in similar situations, auditors should follow the guidance in the following paragraph. In addition, the for-profit enterprise should prepare a schedule of expenditures of federal awards for the program and follow certain other requirements as directed by the awarding agency or by OMB Circular A-133, if applicable. However, for-profit enterprises are not to submit a data collection form or reporting package to the Federal Audit Clearinghouse. Instead, a reporting package should be sent to the federal or state agency requesting the audit.

AUDIT REQUIREMENTS WHEN A PROGRAM-SPECIFIC AUDIT GUIDE IS AVAILABLE

When engaged to conduct a program-specific audit, an auditor should first determine if a *current* program-specific audit guide is available. Program-specific audit guides are prepared by certain federal agencies to give the auditor

specific guidance on matters such as internal control, compliance requirements, suggested audit procedures, and audit reporting requirements for certain programs. The Office of Inspector General (OIG) for each agency is usually responsible for preparing and maintaining such guides and should be contacted to determine if a current guide is available. The contact with the OIG is important because some program-specific audit guides do not reflect the most current information relating to laws and regulations or auditing standards. It is, therefore, important for the auditor to note the date of the guide and to discuss its status including any changes in the requirements with the OIG for the grantor agency and to consider any changes in auditing standards.

If a current program-specific audit guide is available, Section 235(a) of OMB Circular A-133 requires the auditor to follow the guide, generally accepted auditing standards, and *Government Auditing Standards*. The program-specific audit guide dictates the performance and reporting of the audit rather than the requirements for a single audit contained in OMB Circular A-133. However, if not in conflict with the program-specific audit guide, the single audit provisions of OMB Circular A-133 should generally be followed to the extent they are applicable. If significant changes have been made to a program's compliance requirements and the related program-specific audit guide has not been updated to reflect the changes, Paragraph 13.04 of the GAS/A-133 AICPA Audit Guide states that "the auditor should follow Section 235 of Circular A-133 and the *OMB Circular A-133 Compliance Supplement* . . . in lieu of an outdated guide." In addition, it states:

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.

AUDIT REQUIREMENTS WHEN A PROGRAM-SPECIFIC AUDIT GUIDE IS NOT AVAILABLE

If, after contacting the OIG of the appropriate federal agency, the auditor determines that a current program-specific audit guide is not available, Section 235(b) of OMB Circular A-133 states "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." This effectively means performing a single audit on only one federal program. Under this approach the need for an audit and the determination of a major program would already have been determined leaving only the performance of the following audit procedures.

Section 235(b)(3) of OMB Circular A-133 requires the auditor to perform the following procedures in a program-specific audit when a program-specific audit guide is not available. The procedures are consistent with those required for major programs in a single audit.

- a. Perform an audit of the program's financial statement(s) in accordance with generally accepted auditing standards and *Government Auditing Standards*.
- b. Obtain an understanding of internal control over compliance and perform tests of the internal control over compliance for the federal program consistent with the requirements of Section 500(c) of OMB Circular A-133 for a major program.
- c. Perform procedures to determine compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the program consistent with the requirements of Section 500(d) for a major program.
- d. Follow up on prior audit findings and perform procedures to assess the reasonableness of the summary schedule of prior audit findings. A finding by the auditor that the summary schedule materially misrepresents the status of a prior finding should be reported as a finding for the current year.

Auditors are reminded that other provisions of OMB Circular A-133 generally should be followed to the extent they are applicable to program-specific audits. Section 235(d) of OMB Circular A-133 and Paragraph 13.03 of the GAS/A-133 AICPA Audit Guide indicate that the following sections of the Circular apply to program-specific audits to the extent applicable and except when they are contrary to Section 235 of the Circular:

- Purpose; definitions; audit requirements; basis for determining the federal awards expended; subrecipient and vendor determinations; relation to other audit requirements.
- Frequency of audits; sanctions; audit costs.
- Auditee responsibilities; auditor selection.
- Follow-up on audit findings.
- Report submission.
- Responsibilities of federal agencies and pass-through entities; management decisions.
- Audit findings and audit workpapers.
- Other referenced sections of OMB Circular A-133.

Auditor's reports for program-specific audits are discussed later in this lesson.

Compliance Requirements

For programs included in the Compliance Supplement, the auditor should use the matrix presented in Part 2 of the Compliance Supplement to determine which of the 14 requirements apply to the program for an audit performed in accordance with OMB Circular A-133. A "Y" in the program's row on the matrix indicates the applicable compliance requirement applies to that program. The auditor would then refer to Parts 3 and 4 in planning and performing the tests of compliance.

Each type of compliance requirement listed in Part 3 is accompanied by audit objectives and suggested audit procedures that may be used to test for compliance in an OMB Circular A-133 audit, except for program-specific audits performed in accordance with a federal agency's program-specific audit guide. Part 4 contains additional information on the objectives, procedures, and compliance requirements that are unique to each program included.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

30. According to OMB Circular A-133, what is the name for an audit of one federal program?
- a. A single audit.
 - b. A government audit.
 - c. A federal audit.
 - d. A program-specific audit.
31. In order to elect to have a program-specific audit, which of the following is required?
- a. Awards must be expended under more than one federal program.
 - b. A financial statement audit is *not* required by law, regulation, or grant agreement.
 - c. Must be an audit of a research and development program.
 - d. A single audit is required by federal program law, regulation, contract or grant agreement.
32. Together with generally accepted auditing standards and *Government Auditing Standards*, what is the leading authoritative guidance for a program-specific audit?
- a. Single audit provisions of OMB Circular A-133.
 - b. Section 235 of Circular A-133.
 - c. Current program-specific audit guide.
 - d. Circular A-133 Compliance Supplement.
33. Which procedure listed below is **not** an audit requirement when a program-specific audit guide is *not* available?
- a. In accordance with GAAS and *Government Auditing Standards*, perform an audit on the program's financial statements.
 - b. Prepare a schedule of expenditures of federal awards for the program.
 - c. Determine compliance with grant agreements that could have a direct and material effect on the program.
 - d. Understand internal control over compliance and test internal control.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

30. According to OMB Circular A-133, what is the name for an audit of one federal program? **(Page 83)**

- a. A single audit. [This is incorrect. A single audit is an entity-wide audit that includes one or more federal awards and the entity's financial statements.]
- b. A government audit. [This answer is incorrect. This is not a term used in OMB Circular A-133. The audit may or may not be of a government entity depending on who the auditee is.]
- c. A federal audit. [This answer is incorrect. This is not a term used in OMB Circular A-133. There is a better answer.]
- d. A program-specific audit. [This is correct. If an entity meets certain criteria, it may elect a program-specific audit rather than a single audit.]**

31. In order to elect to have a program-specific audit, which of the following is required? **(Page 83)**

- a. Awards must be expended under more than one federal program. [This answer is incorrect. One of the requirements is that awards must be expended under *only one* federal program.]
- b. A financial statement audit is *not* required by law, regulation, or grant agreement. [This answer is correct. This is one of the two requirements for program-specific audit election. The other requirement is that the federal award must be expended under only one federal program.]**
- c. Must be an audit of a research and development program. [This answer is incorrect. In fact, often it is not acceptable for a program-specific audit with the R&D cluster. There are two other conditions (separate from these) that must be met for an R&D program cluster to elect a program-specific audit.]
- d. A single audit is required by federal program law, regulation, contract or grant agreement. [This answer is incorrect. One of the requirements of a single audit is one that must *not* be a requirement for the program-specific audit election. So, if a single audit is required, a program-specific audit cannot be elected.]

32. Together with generally accepted auditing standards and *Government Auditing Standards*, what is the leading authoritative guidance for a program-specific audit? **(Page 85)**

- a. Single audit provisions of OMB Circular A-133. [This answer is incorrect. The performance and reporting of the audit is dictated in another place. However, if not in conflict with the other source, the single audit provisions should be generally followed to the extent they are applicable.]
- b. Section 235 of Circular A-133. [This answer is incorrect. This is where the guidance is named, but not where the guidance is located.]
- c. Current program-specific audit guide. [This answer is correct. Responsibility for these guides lies with the Office of Inspector General for each agency. The auditor should contact them to determine if a current guide is available.]**
- d. Circular A-133 Compliance Supplement. [This answer is incorrect. If the guidance from the correct source is outdated, the auditor should follow current applicable professional standards and guidance which will be contained partially in the Supplement.]

33. Which procedure listed below is **not** an audit requirement when a program-specific audit guide is not available?
(Page 84)
- a. In accordance with GAAS and *Government Auditing Standards*, perform an audit on the program's financial statements. [This answer is incorrect. When a program-specific audit guide is not available, auditors are required to perform this procedure according to Section 235(b)(3) of OMB Circular A-133.]
 - b. Prepare a schedule of expenditures of federal awards for the program. [This answer is correct. This is a requirement of for-profit enterprises that although not required by OMB Circular A-133 to be audited, may still be subjected to the requirements due to the terms of the federal award.]**
 - c. Determine compliance with grant agreements that could have a direct and material effect on the program. [This answer is incorrect. This is one of the required procedures to follow by an auditor when a program-specific guide is not available.]
 - d. Understand internal control over compliance and test internal control. [This answer is incorrect. The auditor is required to obtain an understanding of internal control over compliance and perform tests on it.]

REPORTING REQUIREMENTS

The reporting requirements for a program-specific audit contained in OMB Circular A-133 are very similar to those required for a major program in a single audit. This section discusses those reporting responsibilities. The following paragraphs represent the minimum requirements contained in OMB Circular A-133 and should not imply that additional reports or information cannot be required by appropriate federal agencies.

Unless otherwise indicated, the following requirements may be altered by the provisions contained in a federal agency's current program-specific audit guide. In those instances, the agency's audit guide should be followed. Additional reporting requirements for program-specific audits that must be followed even when an agency audit guide is available are included later in this lesson.

Reporting Package

When a program-specific audit guide is not available, Section 235(c)(3) of OMB Circular A-133 requires the reporting package for a program-specific audit contain the following items:

- a. Financial statement(s) of the federal program, including notes to the statement(s).
- b. Summary schedule of prior audit findings.
- c. Corrective action plan.
- d. Auditor's reports.

Submission of Reports

Submission When a Program-specific Audit Guide Is Not Available. Upon completion of the program-specific audit, the complete reporting package described above and the data collection form, as applicable to a program-specific audit, should be submitted to the federal clearinghouse designated by the Office of Management and Budget.

The 2008 data collection form, which must be used for audits of fiscal periods ending in 2008, 2009, or 2010, can only be completed online and submitted electronically. In addition, the Federal Audit Clearinghouse will now only accept electronic submissions of the reporting package. The data collection form and reporting package must be submitted electronically using the Federal Audit Clearinghouse's Internet Data Entry System (IDES). Submission of anything other than a completed form and reporting package will not be accepted. Detailed instructions for completing the 2008 data collection form and submitting the reporting package are available on the Federal Audit Clearinghouse website at harvester.census.gov/fac/collect08/main_instruct.pdf. The Clearinghouse also provides a "Sample Form SF-SAC Worksheet" that can be downloaded and used to assist in preparing the data collection form. Section 235(c)(1) of OMB Circular A-133 requires the auditee to make complete copies of the reporting package available for inspection by the public unless such access is restricted by law or regulation.

Additional Submission by Subrecipients. In addition to the requirement to submit a copy of the reporting package to the Federal Audit Clearinghouse, subrecipients should also submit one copy of the reporting package to the pass-through entity when (a) an audit finding included in the schedule of findings and questioned costs relates to awards funded through the pass-through entity or (b) the current status of a prior audit finding is reported in the summary schedule of prior audit findings. When neither of these conditions exists, the subrecipient should submit either of the following to the pass-through entity:

- a. A copy of the reporting package.
- b. Written notification that:
 - (1) An audit of the program(s) [include the name(s), amount(s), and CFDA number(s)] was completed in accordance with OMB Circular A-133 and the audit period.

- (2) The schedule of findings and questioned costs disclosed no findings relating to awards funded through the pass-through entity.
- (3) The summary schedule of prior audit findings did not report the status of any audit finding relating to programs funded through the pass-through entity.

Submission When a Program-specific Audit Guide Is Available. Upon completion of a program-specific audit performed in accordance with a federal agency audit guide, of the data collection form along with the reports required by the audit guide should be sent to the federal clearinghouse as indicated above. A copy of the reports required by the program-specific audit guide should also be sent to the awarding federal agency or the pass-through entity. The public inspection requirement discussed above also applies when reporting in accordance with a program-specific audit guide.

CD-ROM Reporting Option. Instead of submitting hard copies of the reporting package, auditees may submit their data collection form and single audit reporting package on a CD-ROM to the Federal Audit Clearinghouse. The Clearinghouse will produce copies as needed for federal agencies. Instructions for CD-ROM submission are available on the Federal Audit Clearinghouse website at <http://harvester.census.gov/sac>.

Report Due Dates

The reporting package for a program-specific audit should be submitted to the proper agencies the earlier of 30 days after the reports are received from the auditors or nine months after the end of the audit period. The due date may be extended by an advance agreement with the federal funding agency or may be changed by the terms of a program-specific audit guide.

Loss of Low-risk Auditee Status. If the reporting package is late and an extension was not granted, a recipient may be disqualified from being a low-risk auditee the next year. Auditors may want to contact the relevant cognizant or oversight agency with questions in this area, including the date of prior-year submissions. The Federal Audit Clearinghouse's searchable database can also be used to look up the date of prior year submissions. It can be accessed at <http://harvester.census.gov/fac>. While low-risk auditee status is not an issue in a program-specific audit because there is only one program, it could be an issue in the following year if the entity expends federal grant funds under more than one program.

Notification of Extension. Section 300(e) of OMB Circular A-133 indicates that when an extension to the report submission due date is granted by the cognizant or oversight agency for audit, the *auditee* should notify the Federal Audit Clearinghouse and the pass-through entity providing the federal award of the extension.

FINANCIAL STATEMENT(S)

The financial statement(s) of a program are a required part of the reporting package of a program-specific audit. Section 235(b)(2) of OMB Circular A-133 requires the financial statements in a program-specific audit to consist of the following *at a minimum*:

- a. Schedule of expenditures of federal awards for the program.
- b. Notes that describe the significant accounting policies used in preparing the schedule.

The Circular does not prohibit including additional financial statements for the program. It just does not require them. This does not, however, prevent a program-specific audit guide or the funding agency from requiring the inclusion of additional financial information on the program.

Prior to the issuance of the 1997 OMB Circular A-133, the financial statement of program-specific audits often took the form of a statement of cash receipts and disbursements. In other instances, a statement of revenues and expenses (expenditures) was prepared and in still others a complete set of program financial statements were prepared in accordance with GAAP. Under the 1997 OMB Circular A-133 (as amended), these statements may still be submitted as long as the schedule of expenditures of federal awards and related notes are also included.

A complete set of GAAP basis or other comprehensive basis of accounting (OCBOA) financial statements can be difficult to prepare and are often no more useful to the grantor agency than the schedule of expenditures of federal

awards. Therefore, unless the grantor agency or a program-specific audit guide indicates differently, the recommendation is for the financial statements to consist only of a schedule of expenditures of federal awards and notes to the schedule. The schedule should contain all of the required information. A suggested format for a schedule of expenditures of federal awards for a single program is presented at Exhibit 3-1.

Exhibit 3-1

**Schedule of Expenditures of Federal Awards
Illustrating Minimum Requirements
ABC Nonprofit Organization
Schedule Of Expenditures Of Federal Awards
Year Ended June 30, 20X1**

Federal Grantor/Pass-through Grantor/Program or Cluster Title	Federal CFDA Number	Agency or Pass-through Entity Identifying Number	Federal Expenditures
U.S. Department of Health and Human Services:			
Direct Award—Head Start	93.600	05CH5560	\$ 437,861

NOTE—BASIS OF PRESENTATION

The schedule of expenditures of federal awards includes the federal grant activity of ABC Organization and is presented on the accrual basis of accounting. The first sentence should identify the basis of accounting used in the schedule. For example, if the cash basis of accounting is used, the first sentence may be modified as follows:

The schedule of expenditures of federal awards includes the federal grant activity of ABC Organization and is presented on the cash basis of accounting, and accordingly, represents the total cash expended for the program. It does not include transactions that might be included using the accrual basis of accounting as contemplated by generally accepted accounting principles.

The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. If a financial statement(s) in addition to the schedule of expenditures of federal awards is presented, the following sentence may be added:

Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the financial statement(s) of the federal program.

In addition, the word “accompanying” should be added as the second word of the first sentence.

* * *

Disclosures

The notes to the schedule of expenditures of federal awards should describe the significant accounting policies used in preparing the schedule. Other disclosures, in addition to those illustrated in Exhibit 3-1, should be included in the schedule or the notes to the schedule when considered necessary. Because of the varied nature of the activities in the various programs, preparation of a list of required disclosures is not practical. However, such disclosures may include questioned costs, contingencies, commitments, risks and uncertainties, subsequent events, unusual and infrequent items of a material amount, related party transactions, and others. (Loans and grants to recipients who meet eligibility requirements need not be disclosed.)

Questioned Costs

Since a program-specific audit covers only the financial activity and related compliance requirements of the program being audited, any findings that may be material to the program should be disclosed in the notes to the

financial statement(s). The effect of the findings on the auditor's report on the financial statement(s) should also be considered.

OMB Circular A-133 does not prohibit additional financial statements. In some instances the grantor agency or the entity may request or require an additional financial statement(s). While the content of these financial statements may vary, they often take the form of a statement of cash receipts and disbursements. Such a statement is illustrated at Exhibit 3-2.

Exhibit 3-2

Illustrated Statement of Cash Receipts and Disbursements^{a, b}

ABC Organization—(Name of Program or Cluster)
Statement of Cash Receipts and Disbursements^c
(CFDA No. xx.xxx)
Year Ended June 30, 20X1

Beginning cash balance	\$ 10,000
Additions: ^d	
Federal advances	60,000
Matching funds	6,000
Interest income	1,000
Program income	5,000
Total Additions	<u>72,000</u>
Deductions: ^d	
Grant disbursements (describe)	74,000
Total deductions	<u>74,000</u>
Ending cash balance	<u>\$ 8,000</u>

NOTE A—BASIS OF PRESENTATION

The accompanying Statement of Cash Receipts and Disbursements has been prepared on the cash receipts and disbursements basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles. Under that basis, the only asset recognized is cash, and no liabilities are recognized. All transactions relating to the Organization's participation in the (name of program) are recognized as either cash receipts or disbursements. Noncash transactions are not recognized in the statement.

Notes:

- ^a The illustration is equally applicable to governmental, nonprofit and for-profit organizations. A schedule of expenditures of federal awards must always be included.
- ^b Other disclosures are omitted from the illustration. These disclosures were discussed previously in this lesson. The notes to the financial statements illustrated at Exhibit 3-1 and Exhibit 3-2 may also be combined.
- ^c Since the financial statement is presented on a basis of accounting other than GAAP, it is titled using terms that do not imply presentation in conformity with GAAP. In addition, the basis of accounting used must be disclosed in the notes to the financial statement.
- ^d The additions and deductions listed are examples and are not intended to imply mandatory line item descriptions. The statement is normally more useful to the grantor agency if the additions and deductions are consistent with the line items from the grant budget or award document.

* * *

AUDITOR'S REPORTS

When performing an audit in accordance with a program-specific audit guide, auditors should follow the guidance and sample reports contained in the guide when drafting the auditor's reports. The reporting guidance and examples in this lesson should be used when a program-specific guide is not available, or does not provide reporting guidance. When a program-specific audit guide is not available, Section 235(b)(4) of OMB Circular A-133 requires that the auditor's report(s) state the audit was performed in accordance with the Circular 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 . . . and findings and questioned costs . . .

The first three items to be included in the auditor's report(s) may be combined, reorganized, or issued separately at the discretion of the auditor.

One of the objectives of the GAS/A-133 AICPA Audit Guide is to reduce the number of reports issued for a single audit. Similarly, the GAS/A-133 AICPA Audit Guide seeks to make program-specific reporting understandable as well as reduce the number of required reports. Paragraph 13.09 of the GAS/A-133 AICPA Audit Guide recommends that the following reports be issued for a program-specific audit:

- An opinion on the financial statement(s) of the federal program.
- A 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.

In certain instances a third report may need to be issued to satisfy Yellow Book reporting requirements.

Yellow Book Reporting Issues

Paragraph 13.10 of the GAS/A-133 AICPA Audit Guide indicates that the auditor does not have to issue a separate Yellow Book report if the financial statement(s) of the program only present the activity of the federal program. The GAS/A-133 AICPA Audit Guide states "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 that case, the reports below "would meet the financial, compliance, and internal control over compliance reporting requirements of both *Government Auditing Standards* and Circular A-133." However, the GAS/A-133 AICPA Audit Guide notes that auditors may issue a separate (third) report addressing Yellow Book requirements. Although usually the financial statement(s) of the program will only present the program's activity, there may be instances where additional activities are included. For example, the financial statements of a municipal sewer district may include both normal operations and activity related to a federal grant to construct a sewage-treatment facility. When the program financial statement(s) include other activities, the auditor should issue a separate Yellow Book report on compliance and on internal control over financial reporting with appropriate report modifications for a program-specific audit [e.g., refer to the financial statement(s) of the program]. When a separate report is issued to meet Yellow Book reporting requirements, an additional paragraph should be added to the report on the financial statement of the program that indicates a Yellow Book report has been issued.

When auditors report separately on internal control over financial reporting and compliance, Paragraph 5.09 of the Yellow Book requires the report on the financial statements to “include a reference to the separate reports and also state that the reports on internal control over financial reporting and compliance with laws and regulations and provisions of contracts or grant agreements are an integral part” of a Yellow Book audit and “important for assessing the results of the audit.”

Report on the Schedule of Expenditures of Federal Awards

The following is an example of an auditor's standard report on the financial statement (in this case, a schedule of expenditures of federal awards) of a federal program issued in connection with the program-specific option under OMB Circular A-133 for submission to government officials or agencies. The report is adapted from Example 13-1 of the GAS/A-133 AICPA Audit Guide.

INDEPENDENT AUDITOR'S REPORT

[Addressee]

We have audited the accompanying schedule of expenditures of federal awards^a for the [Name of Federal Program] of [Name of Governmental Entity or Nonprofit Organization] for the year ended [Date]. This financial statement^b is the responsibility of [Name of Governmental Entity or Nonprofit Organization]'s management. Our responsibility is to express an opinion on the financial statement^b of the program based on our audit.

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*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.^c Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement^b is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement.^b 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 above^a presents fairly, in all material respects, the expenditures of federal awards under the [Name of Federal Program] in conformity with accounting principles generally accepted in the United States of America.^{d, e}

[Firm's Signature]

[City, State]

[Date]

Notes:

- ^a GAS/A-133 AICPA Audit Guide indicates that in many cases, the financial statements of the program will 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 OMB Circular A-133. If the financial statements consist of more than the schedule of expenditures of federal awards, the scope and opinion paragraphs should be modified to describe the financial statement(s).
- ^b Since only one financial statement (the schedule of expenditures of federal awards) is presented, the singular is used in the introductory and scope paragraphs.
- ^c The report for an audit performed in accordance with the Yellow Book or OMB Circular A-133 refers to the financial audit standards in *Government Auditing Standards* as well as to generally accepted

auditing standards. The reference to financial audit standards is made to distinguish them from the attestation and performance audit standards, which are also contained in *Government Auditing Standards*. In addition, the report refers to OMB Circular A-133 because the audit of the program financial statement(s) (the schedule of expenditures of federal awards) was performed in accordance with the Circular.

- d If the financial statement of the program is prepared on a basis of accounting other than GAAP, auditors should follow the guidance in SAS No. 62 (AU 623). SAS No. 62 requires the report to include an additional paragraph that (a) states the basis of presentation and refers to the note to the financial statement that describes the basis, and (b) states that the basis of presentation is a comprehensive basis of accounting other than GAAP. For example, if the schedule of expenditures of federal awards is prepared on the cash basis, the following paragraph would be added before the opinion paragraph:

As described in Note A, this financial statement was prepared on the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

- e GAS/A-133 AICPA Audit Guide indicates that when a separate report is issued to meet Yellow Book reporting requirements, the following additional paragraph should be added:

In accordance with *Government Auditing Standards*, we have also issued our report dated [Date of Report] on our consideration of [Name of Governmental Entity or Nonprofit Organization]'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 over audit.

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

The following is an example of a report on compliance with requirements applicable to the federal program and on internal control over compliance based on an audit performed in accordance with the program-specific option of OMB Circular A-133. An unqualified opinion on compliance is rendered and no material weaknesses or reportable conditions were identified during the audit. The report is adapted from Chapter 13, Appendix A, Example 13-2 of the GAS/A-133 AICPA Audit Guide.

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^a

[Addressee] ^b

Compliance

We have audited the compliance of [Name of Governmental Entity or Nonprofit Organization] with the types of compliance requirements^c described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to [Name of Federal Program] for the year ended [Date]. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of [Name of Governmental Entity or Nonprofit Organization]'s management. Our responsibility is to express an opinion on [Name of Governmental Entity or Nonprofit Organization]'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*, issued by the Comptroller General of the United States;^d and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.^e 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 [Name of Federal Program] occurred. An audit includes examining, on a test basis, evidence about [Name of Governmental Entity or Nonprofit Organization]'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 [Name of Governmental Entity or Nonprofit Organization]'s compliance with those requirements.^f

In our opinion, [Name of Governmental Entity or Nonprofit Organization] complied, in all material respects, with the requirements referred to above that are applicable to its [Name of Federal Program] for the year ended [Date].^g [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 finding reference numbers, for example, X1-1 and X1-2)].^h

Internal Control Over Compliance

The management of [Name of Governmental Entity or Nonprofit Organization] 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 [Name of Governmental Entity or Nonprofit Organization]'s internal control over compliance with requirements that could have a direct and material effect on its [Name of 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 [Name of Governmental Entity or Nonprofit Organization]'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 a 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.ⁱ

[Name of Governmental Entity or Nonprofit Organization]'s response to the findings identified in our audit is described in the accompanying schedule of findings and questioned costs. We did not audit [Name of Governmental Entity or Nonprofit Organization]'s response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, [Specify the body or individuals charged with governance], others within the entity, [Specify legislative or regulatory body], and the federal awarding agency and pass-through entity and is not intended to be and should not be used by anyone other than these specified parties.^j

[Firm's Signature]

[City, State]

[Date] ^k

Notes:

- ^a This report should be used when a program-specific audit guide is not available or does not provide reporting guidance. The report addresses both compliance and internal control over compliance at the federal program level. Footnote 7 to Example 13-2 of the GAS/A-133 AICPA Audit Guide indicates when issuing a qualified or adverse opinion on compliance, the auditor should modify the compliance section of this report.

This report reflects the internal control terminology and definitions applicable in an OMB Circular A-133 audit as provided in Interpretation 1 to SAS No. 112 (AU 9325.01A). This report has not been updated for the guidance in SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*, which supersedes SAS No. 112 (AU 325A) effective for audits for periods ending on or after December 15, 2009. Although the GAO has issued interim guidance on applying SAS No. 115 in a Yellow Book audit, OMB Circular A-133 and other similar federal regulations or audit guides have not been updated to reflect new internal control definitions for reporting on internal control over compliance. The AICPA Audit Risk Alert, *Government Auditing Standards and Circular A-133 Developments—2008*, states that it would not be appropriate to use SAS No. 115 definitions for reporting on internal control over compliance until OMB Circular A-133 or other regulations or guides are amended to allow usage of new updated definitions. When this course went to press, such amendments had not yet been made and the AICPA had not yet developed illustrative reports that reflect SAS No. 115.

- ^b The report is addressed the same as the report on the financial statement(s).
- ^c The report makes a general reference to the OMB Circular A-133 Compliance Supplement (Compliance Supplement). The specific compliance requirements tested should not be listed.
- ^d The report for an audit performed in accordance with the Yellow Book or OMB Circular A-133 refers to the financial audit standards in *Government Auditing Standards* as well as to generally accepted auditing standards. The reference to financial audit standards is made to distinguish them from the performance audit standards, which are also contained in *Government Auditing Standards*. The reference to *Government Auditing Standards* includes the general standards and the fieldwork and reporting standards for financial audits.
- ^e In accordance with Section 505 of OMB Circular A-133, a reference to OMB Circular A-133 is included with the references to GAAS and *Government Auditing Standards* in the second paragraph.
- ^f The last sentence in the second paragraph states that the audit does not provide a legal determination for compliance with the standards mentioned in the second paragraph.
- ^g An opinion is rendered on the federal program's compliance with the requirements in the Compliance Supplement. Even though the compliance requirements for many programs are not included in the Compliance Supplement, this opinion can be expressed because Part 7 of the Compliance Supplement provides guidance to the auditor on determining the compliance requirements for programs not included.

- h The last sentence of the third paragraph lists the reference numbers (from the schedule of findings and questioned costs) of the findings that are required to be reported under OMB Circular A-133. If there is no noncompliance identified in the schedule of findings and questioned costs, this sentence should be omitted.

Paragraph 5.10 of *Government Auditing Standards—2007 Revision* requires auditors to report abuse that could have a material effect on the financial statements. This requirement also applies to program-specific audits. However, Paragraphs 10.45 and 12.36 of the GAS/A-133 AICPA Audit Guide explain that situations or transactions involving federal awards that appear to be abuse are usually instances of noncompliance instead. However, when abuse involving federal awards does occur and could have a material effect on the financial statement amounts, the findings should be reported in the financial statement section of the schedule of findings and questioned costs. In addition, the finding must be referred to in the Yellow Book report (if one is issued) or the Circular A-133 report (if a Yellow Book report is not issued). Abuse that is material to the program should be reported in the federal awards section of the schedule of findings and questioned costs and referred to in the Circular A-133 report. If abuse relates to both the financial statement(s) and federal awards, it should be reported in both, although one may be summarized.

When a separate Yellow Book report is not issued, Paragraph 4.31 of the GAS/A-133 AICPA Audit Guide recommends that findings of abuse be presented in or referred to in the compliance section unless the primary nature of the finding is a significant deficiency or material weakness in internal control. The GAS/A-133 AICPA Audit Guide further recommends that findings of abuse that are significant deficiencies in internal control, it be presented or referred to in the internal control section. Findings that relate to both compliance and internal control are generally reported in both sections, although one may be summarized.

- i This part of the report addresses internal control over compliance with requirements that could have a direct and material effect on the federal program. OMB Circular A-133 requires the report to identify any material weaknesses in internal control that were noted. Both GAAS and the Yellow Book permits reporting that no material weaknesses were noted. When that is done, the report should include the definition of a material weakness, a warning that the audit might not disclose all material weaknesses, and a statement providing negative assurance that the auditor noted no material weaknesses. Paragraph 5.11 of the Yellow Book requires the auditor to report significant deficiencies and material weaknesses in internal control. However, GAAS prohibit the auditor from issuing a written communication stating that no significant deficiencies were identified.
- j The restriction on the distribution of the report is required. Though restricted in use, reports issued in connection with an audit of a local government may be a matter of public record.
- k The report date should be the same as the date of the auditor's report on the financial statement(s) of the program.

Report on the Statement of Cash Receipts and Disbursements and the Schedule of Expenditures of Federal Awards

The program financial statements may include a statement of cash receipts and disbursements in addition to the schedule of expenditures of federal awards. An example of such a statement is at Exhibit 3-2. An illustrated auditors' report on the financial statements illustrated at Exhibit 3-1 and Exhibit 3-2 follows:

INDEPENDENT AUDITOR'S REPORT

[Addressee]

We have audited the accompanying statement of cash receipts and disbursements and schedule of expenditures of federal awards for the [Name of Federal Program] of [Name of Governmental Entity or Nonprofit Organization] for the year ended [Date]. These financial statements are the responsibility of [Name of Governmental Entity or Nonprofit Organization]'s management. Our responsibility is to express an opinion on the financial statements of the program based on our audit.

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*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.^a Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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.

As described in Note A, the financial statements have been prepared on the cash receipts and disbursements basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the statement of cash receipts and disbursements and the schedule of expenditures of federal awards, referred to above present fairly, in all material respects, the cash receipts and disbursements and the expenditures of federal awards under the [Name of Federal Program] for the year ended [Date] on the basis of accounting described in Note A.^b

[Firm's Signature]

[City, State]

Date

Notes:

- ^a The report for an audit performed in accordance with the Yellow Book or OMB Circular A-133 refers to the financial audit standards in *Government Auditing Standards* as well as to generally accepted auditing standards. The reference to financial audit standards is made to distinguish them from the performance audit standards, which are also contained in *Government Auditing Standards*. In addition, the report refers to OMB Circular A-133 because the audit of the program financial statement(s) (the schedule of expenditures of federal awards) was performed in accordance with the Circular.
- ^b Footnote 5 to Example 13-1 of the GAS/A-133 AICPA Audit Guide indicates that when a separate report is issued to meet Yellow Book reporting requirements, the following additional paragraph should be added:

In accordance with *Government Auditing Standards*, we have also issued our report dated [Date of Report] on our consideration of [Name of Governmental Entity or Nonprofit Organization]'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.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

34. What needs to be included in the reporting package when a program-specific audit guide is *not* available?
- a. Financial statements of the whole entity.
 - b. Detailed schedule of prior audit findings.
 - c. Auditor's reports including a budget for next year's funds.
 - d. A corrective action plan.
35. When is a subrecipient required to submit a copy of their reporting package to the pass-through entity?
- a. The subrecipient needs to submit a full copy to the pass-through entity after every audit.
 - b. When an audit finding relates to awards funded directly from the pass-through entity.
 - c. When the current status of a prior audit finding is reported in the summary schedule of prior audit findings.
 - d. The subrecipient never has to submit a full copy to the pass-through entity.
36. Program financial statements are a required part of the reporting package of a program-specific audit. In what format do they need to be?
- a. Schedule of expenditures for the program with notes.
 - b. Statement of cash receipts and disbursements with notes.
 - c. Statement of revenue and expenses with notes.
 - d. Complete set of program financial statements prepared in accordance with GAAP.
37. The preparation of a list of required disclosures is not practical due to the varied nature of the activities in the various programs. Of the disclosures listed below, which one would **not** be required?
- a. Risks, uncertainties and commitments.
 - b. Contingencies and subsequent events.
 - c. Unusual and infrequent items of a material amount.
 - d. Loans to recipients meeting eligibility requirements.
38. When a program-specific guide is *not* available or there is *not* auditor's report guidance in it, what should be included as a separate report in the auditor's report?
- a. A schedule of findings and questioned costs.
 - b. A report on compliance.
 - c. A report on internal control.
 - d. An opinion on financial statements.

39. When does an auditor have to issue a separate Yellow Book report?
- a. When the financial statement of the program only presents the activity of the federal program.
 - b. When financial statement of the program includes other activities.
 - c. When the financial statements of the program consist only of the schedule of expenditures of federal awards.
40. What is it called 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. A significant deficiency.
 - b. A control deficiency.
 - c. A material weakness.
 - d. A material noncompliance.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

34. What needs to be included in the reporting package when a program-specific audit guide is not available? **(Page 90)**
- a. Financial statements of the whole entity. [This answer is incorrect. A copy of the financial statements of the federal program being audited is a required part of the reporting package.]
 - b. Detailed schedule of prior audit findings. [This answer is incorrect. A summary schedule of prior audit findings must be included in the reporting package.]
 - c. Auditor's reports including a budget for next year's funds. [This answer is incorrect. The auditor's report needs to be included, but there is no requirement of next year's budget for the reporting package.]
 - d. **A corrective action plan. [This answer is correct. This plan is required to be a part of the reporting package when a program-specific audit guide is not available. The four items listed are minimum requirements. If the appropriate federal agency requests additional reports or information, the auditor must supply those.]**
35. When is a subrecipient required to submit a copy of their reporting package to the pass-through entity? **(Page 90)**
- a. The subrecipient needs to submit a full copy to the pass-through entity after every audit. [This answer is incorrect. The subrecipient *may* file a copy, but they are not required to unless certain conditions exist.]
 - b. When an audit finding relates to awards funded directly from the pass-through entity. [This answer is incorrect. If funding were coming directly from the entity, it would not be called the pass-through entity. If the audit findings relate to an award funded *through* the pass-through entity, the subrecipient would be required to submit a copy of the reporting package to them.]
 - c. **When the current status of a prior audit finding is reported in the summary schedule of prior audit findings. [This answer is correct. In this case, the subrecipient should submit the package to the pass-through entity as it involves them.]**
 - d. The subrecipient never has to submit a full copy to the pass-through entity. [This answer is incorrect. Under certain conditions, it is required of a subrecipient to send a copy of the report to the pass-through entity.]
36. Program financial statements are a required part of the reporting package of a program-specific audit. In what format do they need to be? **(Page 91)**
- a. **Schedule of expenditures for the program with notes. [This answer is correct. Unless the grantor agency or program-specific audit guide indicates differently, this is all that is required.]**
 - b. Statement of cash receipts and disbursements with notes. [This answer is incorrect. This was the form taken prior to the issuance of the 1997 OMB Circular A-133. After the amendment, this form may still be submitted as long as another format is also included.]
 - c. Statement of revenue and expenses with notes. [This answer is incorrect. This was the form taken prior to the issuance of the 1997 OMB Circular A-133. After the amendment, this form may still be submitted as long as another format is also included.]
 - d. Complete set of program financial statements prepared in accordance with GAAP. [This answer is incorrect. It can be difficult to prepare these statements and not more useful to the agency than the format that is required.]

37. The preparation of a list of required disclosures is not practical due to the varied nature of the activities in the various programs. Of the disclosures listed below, which one would **not** be required? **(Page 92)**
- a. Risks, uncertainties and commitments. [This answer is incorrect. If applicable all of these would need to be disclosed.]
 - b. Contingencies and subsequent events. [This answer is incorrect. If applicable any of these would be required to be disclosed.]
 - c. Unusual and infrequent items of a material amount. [This answer is incorrect. If applicable these items would need to be disclosed.]
 - d. **Loans to recipients meeting eligibility requirements. [This answer is correct. Neither loans nor grants to recipients who meet eligibility requirements need to be disclosed. The other items on this list, if applicable, should be disclosed.]**
38. When a program-specific guide is not available or there is not auditor's report guidance in it, what should be included as a separate report (not combined with other items) in the auditor's report? **(Page 94)**
- a. **A schedule of findings and questioned costs. [This answer is correct. This schedule should include a summary relative to the federal program of the auditor's results concerning findings, questioned costs, etc. This report is not to be combined, reorganized or issued separately.]**
 - b. A report on compliance. [This answer is incorrect. This report is allowed, at the discretion of the auditor, to be combined, reorganized, or issued separately with other required items. This report includes an opinion as to whether the auditee complied with the laws, regulations, and the contract or grant provisions which might have a direct and material effect on the federal program.]
 - c. A report on internal control. [This answer is incorrect. This report is allowed, at the discretion of the auditor, to be combined, reorganized, or issued separately with other required items. The report needs to describe the scope of testing and the results of the tests of internal control.]
 - d. An opinion on financial statements. [This answer is incorrect. This report is allowed, at the discretion of the auditor, to be combined, reorganized, or issued separately with other required items. The opinion is whether the financial statement(s) is presented fairly in all material respects in conformity with the stated accounting policies.]
39. When does an auditor have to issue a separate Yellow Book report? **(Page 94)**
- a. When the financial statement of the program only presents the activity of the federal program. [This answer is incorrect. This is a case when the auditor does *not* have to issue a separate Yellow Book report because all of the Yellow Book requirements are met within that financial statement.]
 - b. **When financial statement of the program includes other activities. [This answer is correct. The Yellow Book report should be on compliance and on internal control over financial reporting with appropriate report modifications for a program-specific audit.]**
 - c. When the financial statements of the program consist only of the schedule of expenditures of federal awards. [This answer is incorrect. This would not cause a separate Yellow Book report to be required. This report would meet the financial, compliance, and internal control over compliance reporting requirements of both *Government Auditing Standards* and Circular A-133.]
40. What is it called 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? **(Page 96)**
- a. A significant deficiency. [This answer is incorrect. A significant deficiency is a control deficiency that adversely affects the entity's ability to administer a federal program. There would be more than a remote likelihood that noncompliance will not be prevented or detected by the entity's internal control.]

- b. A control deficiency. [This answer is correct. This is the definition of a control deficiency.]**
- c. A material weakness. [This answer is incorrect. A material weakness is a significant deficiency 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.]
- d. A material noncompliance. [This answer is incorrect. This is not the definition of material noncompliance. Although material noncompliance can be associated with this definition.]

EXAMINATION FOR CPE CREDIT**Lesson 3 (GSATG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

32. Which of the following is most accurate with respect to single and program-specific audits?
- a. A single audit is an audit of a single federal program.
 - b. A program-specific audit is an entity-wide audit that includes one or more federal awards and the entities financial statements.
 - c. A single audit may be conducted when laws, regulations, or grant agreements do not require a financial statement audit.
 - d. A program-specific audit may be conducted when federal awards are expended under only one program (excluding research and development) and the federal program's laws, regulations, or grant agreements do not require a financial statement audit.
33. Which statement below is correct concerning audit of for-profit enterprises?
- a. The terms of some federal awards demand submission to OMB Circular A-133 requirements.
 - b. A data collection form or reporting package should be sent to the Federal Audit Clearinghouse.
 - c. Compliance with applicable laws and regulations must be ensured by the auditor if funds are passed through to a for-profit subrecipient.
 - d. Audits are required by OMB Circular A-133 for for-profit recipients.
34. What is included in a program-specific audit guide?
- a. Specific guidance on internal control.
 - b. Specific guidance on compliance requirements.
 - c. Audit reporting requirements.
 - d. Specific guidance on internal control, compliance requirements, and audit reporting requirements.
35. Samuel Adams is performing a program-specific audit for which there is no current program-specific audit guide available. What resource below would be most useful to him for assistance in planning the audit?
- a. OIG of the appropriate federal agency.
 - b. The Compliance Supplement.
 - c. Section 235(b) of OMB Circular A-133.
 - d. Government Auditing Standards.

36. Kelly Ann completed the program-specific audit in accordance with a federal agency audit guide. Which of the following statements is correct concerning the submission of reports?
- Kelly should advise her client to send five copies of the data collection form and reports required by the audit guide to the federal clearinghouse.
 - Kelly should advise her client to send a copy of the reports required by the program-specific audit guide to the awarding federal agency or the pass-through entity.
 - Kelly must keep a complete copy of the reporting package available by the public as there is no restriction of such access by law or regulation.
 - Kelly notices that the reporting requirements for program-specific audits are very different from the single audit of a major program which she completed last month.
37. Why is it important for an entity that was subject to a program-specific audit to submit their reports on time?
- There is no penalty or consequence for program-specific auditees.
 - To avoid expensive fines and penalties from the federal clearinghouse.
 - To ensure low-risk auditee status in case federal grant funds are expended under more than one program next year.
 - To ensure funding from the pass-through entity for next year.
38. What should be disclosed in the notes to the financial statements when performing a program-specific audit?
- The list of required disclosures in OMB Circular A-133.
 - Loans to recipients.
 - Grants to recipients.
 - Significant accounting policies.
39. The AICPA Audit Guide lists the recommended reports that should be issued for a program-specific audit. What do these include?
- An opinion on the financial statements, a report on compliance, and on internal control.
 - An opinion on the financial statements and a report on internal control.
 - A report on compliance and a schedule of findings.
 - A report on compliance and a report on internal control.
40. What is required if a separate Yellow Book report is needed?
- Internal control must be reported on separately if a Yellow Book report is required.
 - An additional paragraph added to the report on the financial statement of the program indicating a Yellow Book report has been issued.
 - An additional paragraph added to the report on compliance of the program indicating a Yellow Book report has been issued.
 - An additional paragraph added to the report on internal control of the program indicating a Yellow Book report has been issued.

GLOSSARY

Abuse: 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. Abuse does not necessarily involve fraud violations of laws, regulations, or provisions of a contract or grant agreement.

Cluster of programs: A grouping of closely related programs sharing common compliance requirements that are treated as one program for determining major programs and, with the exception of research and development, whether a program-specific audit may be elected.

Federal awards: Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities.

Instances of noncompliance: cost charged to federal awards that are not reasonable and necessary for the performance and administration of the awards, situations or transactions involving federal awards.

Limited-scope engagement: Agreed-upon procedures engagements conducted in accordance with the AICPA's auditing or attestation standards, under current authoritative literature, all agreed-upon procedures engagements are performed under the attestation standards.

Material effect: Noncompliance with certain laws and regulations could affect the allowability or eligibility of recipients, or material amounts for federal program expenditures.

Materiality: The magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

OMB Circular A-133: *Audits of States, Local Governments and Non-Profit Institutions and Compliance Supplement*. Require the auditor to follow the GAO auditing standards for financial audits contained in the Yellow Book.

Pass-through entity: The entity receiving the federal award directly from the federal agency.

Program-specific audit: An audit of one federal program as provided for in Sections 200(c) and 235 of the Circular.

Questioned costs: Costs that are questioned by the auditor because of an audit finding.

Single Audit: An entity-wide audit that includes one or more federal awards and the entity's financial statements.

Single Audit Act and Amendments of 1996: Establish requirements for audits of states, local governments, and nonprofit organizations that administer federal financial assistance programs above a certain threshold.

Subrecipient: 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.

Vender: 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.

Written assertion: Any declaration or set of related declarations about whether the subject matter is based on or in conformity with the criteria selected.

Yellow Book: The *Government Auditing Standards* written by the General Accountability Office setting forth standards to be followed in auditing the financial statements of entities that receive federal financial assistance.

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COMPANION TO PPC'S GUIDE TO SINGLE AUDITS

COURSE 2

PLANNING THE SINGLE AUDIT AND SINGLE AUDIT SAMPLING (GSATG092)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course provides guidance on how to plan a single audit and how to use sampling as an effective approach for each type of audit procedure. Lesson 1 discusses the planning activities that occur on each engagement. Lesson 2 explains the use of sampling and describes an effective approach for each type of audit procedure.
PUBLICATION/REVISION DATE:	June 2009
RECOMMENDED FOR:	Users of <i>PPC's Guide to Single Audits</i>
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of auditing.
CPE CREDIT:	8 QAS Hours, 8 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours. Yellow Book CPE Credit: This course is designed to assist auditors in meeting the continuing education requirements included in GAO's Government Auditing Standards.
FIELD OF STUDY:	Auditing (Governmental)
EXPIRATION DATE:	Postmark by July 31, 2010
KNOWLEDGE LEVEL:	Basic

Learning Objectives:**Lesson 1—Planning the Single Audit**

Completion of this lesson will enable you to:

- List the auditing and reporting considerations and describe the relationship with and responsibilities of the cognizant or oversight agency for audit and identify the major federal award programs.
- Compare and contrast between the state and local grant compliance requirements.
- Classify the various types of risk assessment and other planning procedures.
- Explain the significance of understanding the entity and its environment when developing an audit plan; and how planning decisions and judgments are relative to a single audit.
- Explain an auditor's responsibility when considering the risks of material misstatements due to fraud.
- Describe the overall aspects of audit programs and documentation requirements.
- Determine how and when other auditors should be used to perform different portions of the audit.

Lesson 2—Single Audit Sampling

Completion of this lesson will enable you to:

- List the requirements that apply to all single audit samples and explain the objective and purpose of the tests of controls over compliance.
- Identify the steps in planning the audit sample.
- Explain the purpose of compliance tests.
- Describe the auditor's consideration for when assessing the various steps for a nonstatistical sampling approach to substantive tests of compliance.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
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GSATG092 Self-study CPE
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Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Planning the Single Audit

INTRODUCTION

This lesson discusses the planning activities in a single audit engagement that begin after the auditor has accomplished the following important steps:

- Identified the financial reporting entity.
- Determined the amount of federal awards expended and the need for a single audit.
- Determined the scope of services to be provided, including the reports to be issued.
- Established the terms of the engagement in an engagement letter.

Pre-engagement activities are particularly important in an initial engagement but still require careful attention each year in a continuing engagement. Pre-engagement activities provide important information for audit planning (i.e., the need to meet single audit requirements affects audit scope and the number and types of reports to be issued).

This lesson discusses the planning activities that take place on each engagement. Preliminary planning involves deciding on an overall strategy for the audit, obtaining an understanding of the entity and its environment, including its internal control, making an initial assessment of audit risk and materiality, and deciding on the overall timing of the engagement. In a single audit, planning also involves identifying major grant programs; identifying federal, state, and local grant compliance requirements; and assessing the risk of material noncompliance. This lesson also discusses other matters that are particularly pertinent to a single audit, including the failure to follow *Government Auditing Standards*, and reliance on other auditors.

Learning Objectives:

Completion of this lesson will enable you to:

- List the auditing and reporting considerations and describe the relationship with and responsibilities of the cognizant or oversight agency for audit and identify the major federal award programs.
- Compare and contrast between the state and local grant compliance requirements.
- Classify the various types of risk assessment and other planning procedures.
- Explain the significance of understanding the entity and its environment when developing an audit plan; and how planning decisions and judgments are relative to a single audit.
- Explain an auditor's responsibility when considering the risks of material misstatements due to fraud.
- Describe the overall aspects of audit programs and documentation requirements.
- Determine how and when other auditors should be used to perform different portions of the audit.

AICPA Risk Assessment SASs. In March 2006, the AICPA issued eight SASs on risk assessment. The overall objective of the risk assessment standards is to promote the auditor's use of a risk assessment model in GAAS audits by requiring the following:

- A greater understanding of the entity and its environment, including internal control, to identify the risks of material misstatement in the financial statements, along with the entity's actions to mitigate those risks.
- A heightened assessment of the risks of material misstatement based on the auditor's understanding.
- Better linkage between the assessed risks and the resulting audit procedures.

The risk assessment SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006. This means that for audits of entities that do not have a calendar year end, the risk assessment standards must be implemented for audits of financial statements for the year that begins in 2007 and ends in 2008.

Government Auditing Standards, July 2007 Revision. *Government Auditing Standards, 2007 Revision*, supersedes the 2003 revision. Chapters 1–5 of the 2007 Yellow Book are applicable to financial audits. The 2007 Yellow Book is effective for financial audits for periods beginning on or after January 1, 2008 (calendar 2008 or fiscal 2009 year ends).

Objectives of Audit Planning

The first standard of fieldwork states that “the auditor must adequately plan the work and must properly supervise any assistants.” According to SAS No. 108, *Planning and Supervision*, audit planning involves “developing an overall audit strategy for the expected conduct, organization, and staffing of the audit.” Audit strategy is the auditor’s operational approach to achieving the objectives of the audit. It is a high-level description of the audit scope. It includes matters such as identifying material locations and account balances, identifying audit areas with a higher risk of material misstatement or noncompliance, the overall responses to those higher risks, and the planned audit approach by area (for example, substantive procedures or a combined approach of substantive procedures and tests of controls).

An overriding objective throughout the planning process is the identification of risks that should be considered and an assessment of whether the risks could result in material misstatement or noncompliance. According to SAS No. 108, obtaining an understanding of the entity and its environment, including its internal control, is an essential part of planning the audit. Auditors must plan the audit so that it is responsive to the assessment of the risk of material misstatement/noncompliance based on the auditors’ understanding of the entity and its environment, including its internal control.

Audit planning also includes development of an audit plan (also called the audit program). The audit plan is more detailed than the audit strategy and documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence.

The nature, timing and extent of audit planning varies with the size and complexity of the entity and with the auditor’s understanding of the entity and its environment, including internal control. However, audit planning always includes a risk assessment process.

The Risk Assessment Process

The risk assessment process involves performing procedures, obtaining an understanding of various matters about the entity and its environment, and making decisions and judgments about assessed risks and other matters based on the understanding.

Procedures Performed. Risk assessment procedures include inquiry, analytical procedures, inspection, and observation as well as related planning activities and procedures, including preliminary engagement activities related to client acceptance and continuance, and holding a discussion among the engagement team. The auditor is required to perform all of these procedures when planning the audit.

The auditor’s consideration of fraud required by SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, is not separate from the consideration of audit risk but is integrated into the overall risk assessment process. That is, the assessment of risks due to error occurs simultaneously with the assessment of risks due to fraud. According to Paragraph 6.25 of the GAS/A-133 AICPA Audit Guide, “the auditor should specifically assess the risk of material noncompliance with a major program’s compliance requirements occurring due to fraud,” and should consider that assessment when designing audit procedures. The key requirements of SAS No. 99 are addressed at relevant points throughout this course.

Understanding Obtained. As explained in detail later in this lesson, risk assessment procedures are performed to obtain an understanding of the entity and its environment, including its internal control. The auditor obtains information about the following:

- a. Industry, regulatory and other external factors.
- b. Nature of the entity.

- c. Objectives and strategies and the related operating risks that may result in material misstatement/noncompliance.
- d. Measurement and review of the entity's financial performance.
- e. Internal control, which includes the selection and application of accounting policies.
- f. Fraud risk factors.

Decisions and Judgments Made. The information obtained by applying risk assessment procedures is used to make the important decisions and judgments that are part of audit planning. These decisions and judgments include determining materiality levels and assessing risks of material misstatement/noncompliance. Paragraph 6.19 of the GAS/A-133 AICPA Audit Guide explains that the auditor considers audit risk and materiality together for each major program being tested and for each direct and material compliance requirement when determining the nature, timing, and extent of audit procedures and evaluating the results of the procedures.

AUDITING AND REPORTING CONSIDERATIONS

Audit Requirements for a Single Audit

The objectives and components of a single audit relate to the financial statements, internal control, and compliance with laws, regulations, and the provisions of contracts or grant agreements. The auditor's objectives in a single audit include (a) performing an audit of the financial statements and reporting on the schedule of expenditures of federal awards and (b) performing a compliance audit of federal awards.

When performing a single audit in accordance with OMB Circular A-133, the auditor is required to determine whether—

- The entity's financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP) (or an other comprehensive basis of accounting) and the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the entity's financial statements taken as a whole.
- The entity has internal controls that provide reasonable assurance that the entity is in compliance with the applicable laws, regulations, and compliance requirements of its major programs. As part of performing a compliance audit, the auditor is required to obtain an understanding of the internal control over compliance for each major program, assess control risk, and test the controls (unless the controls are considered to be ineffective).
- The entity has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each major federal program.

Reports Required in a Single Audit

OMB Circular A-133 requires the auditor to report on each aspect of the audit. The reports may be classified as those relating to the financial statements of the reporting entity and those relating to the entity's federal award programs and include the following:

Reports Related to Financial Statements of the Reporting Entity Required by Government Auditing Standards

- a. Opinion (or disclaimer of opinion) on whether the financial statements are presented fairly in all material respects in conformity with GAAP.
- b. Report on internal control over financial reporting disclosing significant deficiencies and material weaknesses in internal controls based solely on the understanding obtained and any testing performed

in the audit of financial statements. The report should also disclose the scope of testing of internal controls, if any, and whether the tests performed provided sufficient, appropriate evidence to support an opinion on internal controls.

- c. Report on compliance with laws, regulations, and provisions of contracts or grant agreements, disclosing fraud and illegal acts that are more than inconsequential and material abuse or noncompliance. (Reporting fraud, illegal acts, noncompliance, or abuse that is inconsequential is considered to be a matter of the auditor's professional judgment.)

Reports Related to Federal Award Programs Required by OMB Circulars A-133 in Addition to Items a. through c.

- d. An *in relation to opinion* (SAS No. 29) (or disclaimer of opinion) on the supplementary schedule of expenditures of federal awards. The schedule presents total federal awards expended for each program.
- e. Report on internal control over compliance applicable to major programs.
- f. 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.
- g. Schedule of findings and questioned costs that includes a summary of the auditor's results.

The Yellow Book and OMB Circular A-133 allow the auditor's report(s) to be in the form of either combined or separate reports. The illustrative reports provided by the AICPA combine the reporting on compliance and internal control required by *Government Auditing Standards* into a single report and the reporting on internal control over major programs and major program compliance required by OMB Circular A-133 into a single report.

Planning Considerations

In planning a single audit, the auditor should consider both the requirements of an audit of financial statements in accordance with GAAS and the requirements of a single audit. The auditor should also perform follow-up procedures to assess the reasonableness of the summary schedule of prior audit findings (i.e., whether the client has accurately represented the status of planned corrective actions). The auditor shall report, as a current year audit finding, when the auditee materially misrepresents the status of any prior audit finding. The auditor has to perform audit follow-up procedures even for prior audit findings that do not relate to a major program in the current year. The effect of any prior year findings remaining unresolved should be evaluated when planning the current year engagement.

Follow-Up Procedures for Prior Audit Findings. Procedures performed in the current audit often provide a basis for the auditor to assess the summary schedule of prior audit findings. Sometimes, however, it may be necessary for the auditor to perform procedures that specifically address the status of prior audit findings. The GAS/A-133 AICPA Audit Guide, Paragraph 10.62, explains that the procedures might include the following:

- Making inquiries of management and program personnel, including inquiries about the status of corrective actions and the expected completion date for incomplete actions.
- Reviewing management decisions issued by federal awarding agencies or pass-through entities.
- Observing an activity that has been redesigned to address a prior-year finding.
- Testing similar current-year transactions.

RELATIONSHIP WITH AND RESPONSIBILITIES OF THE COGNIZANT OR OVERSIGHT AGENCY FOR AUDIT

Cognizant Agency for Audit

Recipients expending more than \$50 million a year in federal awards will have a designated cognizant agency for audit. The designated cognizant agency for audit will 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. To provide for continuity of cognizance, the determination of the predominant amount of direct funding is based upon direct federal awards expended in the recipient's fiscal years ended or ending in 2004, 2009, and every fifth year thereafter. For example, audit cognizance for periods ended or ending in 2006–2010 would be determined based on federal awards expended in 2004. This means that cognizance will remain with the same federal agency for at least five years. OMB Circular A-133 allows the federal awarding agency with cognizance for an auditee to reassign cognizance to another federal awarding agency if it both 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 will notify the auditee, and, if known, the auditor of the reassignment. Likewise, when making specific cognizant agency for audit assignments, OMB will inform the parties involved (e.g., the auditee and the federal agencies involved) of the assignment. The preamble to OMB Circular A-133 states that—

OMB expects to designate specific audit cognizance assignments for only a limited number of entities. However, if a change in audit cognizance is desired, then auditees are expected to first work through their Federal awarding agencies to obtain a reassignment. If the request cannot be adequately resolved among the Federal agencies, then the Federal agencies may contact OMB to resolve the matter.

Revisions to OMB Circular A-21 assign cost negotiation cognizance for educational institutions to certain federal agencies depending on specified criteria. As a result it is possible that an entity may have different cognizant agencies for audit and indirect cost rate negotiation purposes. To recognize different responsibilities and to clearly distinguish between the two types of cognizant agencies, the 1997 OMB Circular A-133 uses the term “cognizant agency for audit.”

Responsibilities of the Cognizant Agency for Audit. Section 400(a) of OMB Circular A-133 and Paragraph 5.42 of the GAS/A-133 AICPA Audit Guide list the following responsibilities of a cognizant agency for audit:

- Provide technical audit advice and liaison to auditees and auditors.
- Consider auditee requests for extensions to the report submission due date. (Extensions may be granted for good cause.)
- Obtain or conduct quality control reviews of selected audits made by non-federal auditors, and provide the results, when appropriate, to other interested organizations.
- Promptly inform other affected federal agencies and appropriate federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities (fraud) or illegal acts, as required by *Government Auditing Standards* or laws and regulations.
- 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 should work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit is required to 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 will be referred to appropriate state licensing agencies and professional bodies for disciplinary action.
- Coordinate, to the extent practical, audits or reviews made by or for federal agencies that are in addition to the audits made pursuant to OMB Circular A-133, so that the additional audits or reviews build upon audits performed in accordance with OMB Circular A-133.

- Coordinate a management decision for audit findings that affect the federal programs of more than one agency.
- Coordinate the audit work and reporting responsibilities among auditors to achieve the most cost-effective audit.
- For biennial audits permitted under Section 220 of OMB Circular A-133, consider auditee requests to qualify as a low-risk auditee under Section 530(a).

The auditor should note that the cognizant agency for audit is not required to approve the recipient's selection of an independent auditor. While OMB Circular A-128 has been rescinded, OMB has indicated that until additional guidance is available, the guidance in *Questions and Answers on the Single Audit Process of OMB Circular A-128, "Single Audits of State and Local Governments"* (A-128 Q&As) (included in PPC's *Government Documents Library* at Gov. Doc. No. 15) may still be useful if it is not contrary to the requirements in the 1997 Circular A-133. Therefore, it is believed that the guidance in the A-128 Q&As continues to be beneficial. *Question No. 45 of Questions and Answers on the Single Audit Process of OMB Circular A-128, "Single Audits of State and Local Governments,"* (A-128 Q&As) states—

The selection of an independent auditor is a recipient responsibility and the process is often addressed in State law. Prior approval is not required by the Federal cognizant agency [for audit], although the Federal cognizant audit agency [for audit] can provide advice for those recipients that have little or no experience in arranging for audit service.

When selecting an independent auditor, recipients should, however, follow applicable procurement standards. Nonprofit organizations should follow procurement standards prescribed by OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations* (included in PPC's *Government Documents Library* at Gov. Doc. No. 6); governmental units should follow standards prescribed by OMB Circular A-102 (Common Rule), *Grants and Cooperative Agreements with State and Local Governments* (included in PPC's *Government Documents Library* at Gov. Doc. No. 5). Also, OMB Circular A-133 indicates that the procurement standards of the Federal Acquisition Regulation (48 CFR part 42) are applicable for certain entities instead of OMB Circular A-110. These standards provide guidelines to ensure that services are obtained in an economical and efficient manner that provides open and free competition. In addition, OMB Circular A-133 provides guidelines to ensure that small, minority-owned and woman-owned audit firms have the opportunity to participate in audits of federal awards.

Guidance for Cognizant Agencies for Audit

The responsibilities and operating procedures of cognizant agencies for audit are covered in detail in the *Federal Cognizant Agency Audit Organization Guidelines*, October 1985 (included in PPC's *Government Documents Library* at Gov. Doc. No. 14). This publication provides guidelines in the following areas:

- Promoting quality audits.
- Processing audit reports.
- Defining major inadequacies.
- Providing notification of fraud.

This publication was prepared prior to the issuance of the 1997 OMB Circular A-133. While certain specific information may no longer be applicable, auditors may wish to review the guidelines to obtain a better appreciation of the expectations of cognizant agencies and the assistance they can offer. Although each federal agency has agreed to follow these guidelines, the guidelines are limited to broad policy statements that allow federal agencies to determine the specific design and implementation of procedures. The auditor should not assume that all conditions agreed to for one engagement will be acceptable for another engagement.

Oversight Agency for Audit

The OMB has assigned cognizant agencies for audit for larger governmental and nonprofit entities. Section 400(b) of OMB Circular A-133 states that an auditee that does not have a designated cognizant agency for audit will be under the general oversight of the federal 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.

Section 105 of OMB Circular A-133 provides the preceding definition and refers to these agencies as “oversight agencies for audit.”

Responsibilities of the Oversight Agency for Audit. While the role of an oversight agency for audit is similar to that of a cognizant agency for audit, the OMB has stated that the responsibilities of an oversight agency for audit are not as broad as those of a cognizant agency for audit. Section 400(b) of the Circular and Paragraph 5.44 of the GAS/A-133 AICPA Audit Guide list the following responsibilities for an oversight agency for audit:

- Provide technical advice to auditees and auditors as requested.
- Assume all or some of the responsibilities described earlier in this lesson, normally performed by a cognizant agency for audit.

Thus, the extent of responsibilities taken on by the oversight agency for audit will vary.

OMB Circular A-133 allows for reassignment of an oversight agency for audit. Section 105 of OMB Circular A-133 states that:

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.

Cognizant and Oversight Agencies for Audit—Identification Issues

During implementation of OMB Circular A-133, several issues have arisen regarding both identification of cognizant and oversight agencies for audit and reporting such information on the data collection form. These issues generally relate to (a) whether the auditee should have a cognizant or an oversight agency for audit and (b) how to determine the proper agency.

Cognizant versus Oversight Agency for Audit. Auditees must first consider whether they should have a cognizant or an oversight agency for audit. Only entities expending more than \$50 million a year in federal awards will have a designated *cognizant* agency for audit. The designated cognizant agency for audit will be the federal awarding agency that provides the predominant amount of direct funding to a recipient unless OMB makes a specific cognizance assignment. Auditees that expend \$50 million or less a year in federal awards will have an *oversight* agency for audit.

Direct versus Indirect Funding. If the OMB has not made a specific cognizant agency for audit assignment, the entity's cognizant agency for audit is the federal agency that provides the predominant amount of direct funding. Similarly, an auditee expending \$50 million or less in federal awards in a year would identify its oversight agency for audit as the federal agency that provides the predominant amount of direct funding. Key considerations are that the cognizant or oversight agency must be a *federal agency* and the deciding factor is *direct funding* (not indirect or total funding) from the agency. Direct funding has precedence over any amount of indirect funding. Thus, the federal agency that provides the most direct funding to an auditee is the cognizant or oversight agency for audit, even in situations where indirect federal awards exceed direct awards (absent a specific cognizance assignment by OMB). If the auditee does not receive any direct funding, the federal agency providing the most indirect funding would be the oversight agency for audit. A common mistake has been identification of pass-through entities, such as state agencies, as cognizant or oversight agencies for audit.

Case Study—Determining the Cognizant or Oversight Audit Agency. The following case study on determination of the agency with audit cognizance or oversight responsibilities illustrates some of the issues discussed in the preceding paragraphs:

The Isola Independent School District (ISD) has expended federal awards as follows:

<u>U.S. Department of Education</u>		
Passed through State Education Agency:		
ESEA Title I, Part A, Title I Grants to Local Education Agencies	84.010	\$ 1,700,000
ESEA Title I, Part C, Migrant Education—State Grant Program	84.011	800,000
ESEA Title V, Part D, Foreign Language Assistance	84.293	350,000
ESEA Title I, Part G, Advanced Placement Program	84.330	350,000
<u>U.S. Department of Agriculture</u>		
Food Donation Program	10.550	<u>150,000</u>
Total		<u>\$ 3,500,000</u>

Because Isola ISD has not expended more than \$50 million in federal awards during the year, it will have an oversight agency for audit. Although Isola ISD received the predominant amount of its federal funding from the State Education Agency, their oversight agency for audit would be the U.S. Department of Agriculture. As previously indicated, the oversight agency for audit is the *federal* agency that provides the predominant amount of *direct* funding. In this example, the oversight audit agency would change if commodities received from the Food Distribution Program were passed through the State Department of Health and Human Services. In that case, Isola would not have received any direct funding; thus, the federal agency providing the most indirect funding (U.S. Department of Education) would be the oversight agency for audit. Note that the State Education Agency would not be the oversight agency for audit since the oversight entity must be a federal agency.

Communications with the Cognizant or Oversight Agency for Audit

Early in the engagement, the auditor should determine, through discussion with the client and review of relevant correspondence, whether a cognizant agency for audit has been assigned. [Cognizant agencies for audit have been instructed to contact auditees (and their auditors, if known) within 30 days of any reassignment; thus, the client should be aware if one has been assigned.] If not, the auditor can determine the oversight agency for audit by determining which federal agency provides the most direct funding to the client. Auditors should also be aware that states that pass through federal awards to subrecipients may establish state cognizant audit agencies for state single or other compliance audit purposes. Thus, the organization may have two cognizant or oversight agencies for audit—a cognizant agency for audit at the state level (state single audit) and a cognizant or oversight agency for audit at the federal level (OMB Circular A-133 audit). Note that an auditee may only have one federal agency designated as its cognizant or oversight agency for audit for purposes of performing an OMB Circular A-133 audit. The auditor should also note that it is the prerogative of the cognizant or oversight agency for audit as to what office within the agency will be assigned to the organization. Oversight responsibilities may be assumed by program officials, audit officials, or both. Once the applicable cognizant or oversight agency for audit is identified, the auditor may communicate with it early in the planning stages of the single audit and during the audit itself if problems or questions arise that cannot be resolved at the local level.

There is no requirement for the cognizant or oversight agency for audit to approve the audit scope or plan in advance of the audit. Paragraph 6.38 of the GAS/A-133 AICPA Audit Guide notes that auditors may communicate with the cognizant or oversight agency for audit to aid in planning the audit. Auditors should consider documenting such communications, as well as any decisions reached during the communication. If a planning meeting is held, the auditor should consider discussing the following matters:

- The scope of the compliance testing of federal programs.
- The intended use of the Compliance Supplement.

- Identification of federal programs, including those considered to be major programs.
- The form and content of the schedule of expenditures of federal awards.
- Testing of the pass-through entity's monitoring of subrecipients.
- The scope of the review and testing of internal control over compliance.
- 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.
- The reports that the auditor plans to issue at the completion of the single audit.
- Problem areas that the auditor should be aware of (e.g., potential fraud or problems with management, changes in grant programs in the current year, problems in monitoring subrecipients, etc.).

Any communications with the cognizant or oversight agency for audit should be documented in the auditor's workpapers, and any disagreements between the auditor, the organization, and the cognizant or oversight agency for audit should be resolved prior to beginning fieldwork. Auditors should also consider whether any communication is necessary with other federal awarding agencies, pass-through entities, state auditors, or state awarding agencies.

DETERMINING MAJOR FEDERAL AWARD PROGRAMS

The concept of a *major* federal award program is crucial to establishing the scope of tests performed in a single audit. This is because the Single Audit Act Amendments and OMB Circular A-133 focus on *major* federal award programs in determining the extent of tests of controls and whether additional tests of compliance with laws, regulations, and the provisions of contracts or grant agreements are necessary. OMB Circular A-133 defines a major program in terms of federal awards expended during a fiscal year. The auditor should note that under OMB Circular A-133, both the threshold for requiring a single audit and the determination of a major program is based on federal awards *expended*. OMB Circular A-133 provides non-federal entities with the option of having the single audit performed on a departmental, agency, or other organizational unit basis. If the single audit is performed on such basis, total federal awards expended for the department, agency, or other organizational unit would be used for determining major programs.

American Recovery and Reinvestment Act of 2009 Considerations

The American Recovery and Reinvestment Act of 2009 (Recovery Act) has significant implications for single audits, including the most basic step of determining major programs. Appendix VII of the 2009 Compliance Supplement states that auditors should consider all programs with expenditures of Recovery Act funds to be "programs of higher risk" in accordance with OMB Circular A-133. However, Appendix VII cautions auditors that the Compliance Supplement was not updated for revisions needed for the Recovery Act—CFDA numbers, compliance requirements, and cluster identification for Recovery Act funds are not included. Until additional guidance becomes available, auditors will not be able to finalize their major program determination if the auditee has expended Recovery Act funds. The OMB plans to periodically issue additional guidance in addenda to the Compliance Supplement. The authors recommend that auditors closely monitor the OMB website www.whitehouse.gov/omb/agency/default/ and the CFDA website www.cfda.gov for updated information.

Program Identification—Programs and Clusters of Programs

The auditor should note that the amounts expended relate to *programs*, not separate awards. This means that if a governmental or nonprofit organization has several grants that support a single federal award program, such as

several Community Development Block Grants, the total of all grants supporting the program must be determined before applying the risk-based approach. All grants with the same *Catalog of Federal Domestic Assistance* (CFDA) number should be combined as a single program. When a pass-through entity passes through federal funding to a subrecipient, it is the pass-through entity's responsibility to provide the subrecipient with identification of the source of funding. If a pass-through entity does not provide the subrecipient with the applicable CFDA number, the subrecipient should attempt to identify the number by contacting the pass-through entity or reviewing the CFDA. For awards not assigned a CFDA number, combine all awards provided by the same agency for the same purpose. A cluster of programs, as defined in the following paragraph, is also considered a federal program.

Cluster of Programs. OMB Circular A-133 broadens the definition of federal programs to address a "cluster of programs." A cluster of programs is a grouping of closely related programs sharing common compliance requirements. The types of clusters of programs include the following:

- a. Research and development (R&D).
- b. Student financial aid.
- c. Other clusters, as defined by OMB or as designated by the state.

A cluster of programs should be treated as a single program when determining major programs and, with the exception of R&D, whether a program-specific audit may be elected. Because of the broadened definition of a federal program, programs with similar compliance requirements will be evaluated on a combined basis instead of as individual programs. Through "clustering," certain programs that individually did not meet the previous criteria for a major program will more likely be selected as major programs under the risk-based approach.

OMB Circular A-133, section 105, indicates that "other clusters" are programs defined by the OMB in the compliance supplement or designated by a state for federal awards passed through to its subrecipients that meet the definition of a cluster of programs. When designating an "other cluster," Section 105 requires the state to identify the federal awards included in the cluster and advise the subrecipients of compliance requirements applicable to the cluster, consistent with the responsibilities of pass-through entities. Part 5 of the *OMB Circular A-133 Compliance Supplement* (a link to the Compliance Supplement is included in *PPC's Government Documents Library* at Gov. Doc. No. 9) identifies programs that are considered to be clusters of programs under OMB Circular A-133. Part 5 also provides compliance requirements, audit objectives, and suggested audit procedures for the R&D and student financial aid clusters.

Programs identified as part of a cluster may not be "unclustered" when determining major programs. All programs in a cluster must be evaluated together under the four-step risk-based approach. Thus, if selected as a major program, all individual programs that the entity has within the cluster must be tested as a major program. The only instance where "reclustering" is allowed is when a state government combines different federal awards into a combined program that is passed through to a subrecipient *and* the state requires the subrecipient to treat the combined program as a single program.

Single Audit Risk-based Approach

Paragraph 8.01 of the GAS/A-133 AICPA Audit Guide notes that while OMB Circular A-133 indicates auditees are responsible for identifying all federal awards received and expended and the federal programs under which they were received (as well as preparing the schedule of expenditures of federal awards), the responsibility for identifying major programs is placed on the auditor. Section 520 of OMB Circular A-133 prescribes a risk-based approach to determining which federal programs are major programs. When using a risk-based approach, the auditor focuses on programs that have a higher risk of noncompliance occurring instead of focusing on programs with large dollar expenditures. The approach includes consideration of the following:

- Current and prior audit experience.
- Oversight by federal agencies and pass-through entities.
- Inherent risk of the program.

Section 525(a) of OMB Circular A-133 indicates “the auditor’s determination [of federal program risk] should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the Federal program.” Auditors should use professional judgment and consider the criteria in Exhibit 1-1 to identify risk in federal programs. Auditors may also consult with entity management and the granting agency concerning particular programs.

Exhibit 1-1

Federal Program Risk Criteria

Current and Prior Audit Experience:

- Weaknesses in internal control over federal programs.
- Control environment over compliance for federal programs.
- Management’s adherence to applicable laws and regulations and the provisions of contract and grant agreements.
- Competence and experience of personnel who administer federal programs.
- Whether the program is administered under multiple or single internal control structures and whether any deficiencies are systemwide or confined to one structure.
- Whether the program has subrecipients and the strength of the subrecipient monitoring system.
- The extent and complexity of computer processing used to administer federal programs and the auditor’s experience with them.
- Prior audit findings, including whether the auditee has taken appropriate corrective action to address findings and recommendations that could have a material effect on the financial statements.
- Whether a program has recently been audited as a major program.

Oversight by Federal Agencies and Pass-through Entities:

- Whether recent reviews by oversight entities have disclosed significant problems or findings.
- Whether a federal agency, with the concurrence of OMB, has identified a program as higher risk.

Inherent Risk of the Program:

- The nature of the program, including the complexity and extent to which the program contracts for goods and services (e.g., inherent risk in programs with eligibility criteria or that use contractors to disburse funds).
- The phase of a program in its life cycle (program maturity) at the federal agency and the auditee (e.g., new programs with new or interim regulations may have higher risk than established programs with well established requirements).
- Whether there have been significant changes in programs, laws, regulations, or the provisions of contracts or grant agreements.
- The size of the program (e.g., programs with larger expenditures).

* * *

OMB Circular A-133 describes a four-step process to determine major programs. The auditor should adequately document the risk evaluation process and the selection of major programs for testing. If major programs are

determined and documented in accordance with Circular A-133, Section 520(h) states “the auditor’s judgment in applying the risk-based approach to determine major programs shall be presumed correct.” Federal agencies and pass-through entities may only challenge the auditor’s judgment “for clearly improper use of the guidance” in OMB Circular A-133.

Step 1—Identify Type A and Type B Programs

Under OMB Circular A-133, programs are classified as either “Type A” or “Type B” programs. For this purpose, federal awards expended 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 related notes. (If the prior-year schedule or preliminary current-year estimates are used to plan the audit, the auditor should recalculate the threshold for Type A programs based on the final amounts to ensure that awards are properly classified as Type A or B). A Type A program is determined based on the formulas presented in Exhibit 1-2, which are included in Section 520(b) of the Circular.

Exhibit 1-2

Determining Type A Programs

If Total Federal Awards Expended Are:	A “Type A” Program Is Any Program with Federal Awards Expended of:
\$500,000 to \$100 million	The larger of \$300,000 ^a or 3% (.03) of total federal awards expended
\$100,000,001 to \$10 billion	The larger of \$3 million or .3% (.003) of total federal awards expended
Above \$10 billion	The larger of \$30 million or .15% (.0015) of total federal awards expended

Note:

^a Even though the single audit threshold is \$500,000, the minimum Type A program threshold is \$300,000.

* * *

Because most small entities do not expend more than \$100 million of federal awards, they will usually be in the first category of the formula, which defines Type A programs as the larger of \$300,000 or 3% of total federal awards expended. Auditors should note that entities with large increases in federal expenditures because of the American Recovery and Reinvestment Act of 2009 may no longer have a \$300,000 threshold for determining Type A programs. Instead, the entities may have a higher threshold. Any programs that do not meet the Type A criteria specified in Exhibit 1-2 are considered Type B programs.

Treatment of a Loan or Loan Guarantee Program. A governmental unit or nonprofit organization operates a federal loan or loan guarantee program, the value of loans and loan guarantees should be excluded from the base (total federal awards) for applying the formula if including them significantly affects the number of other programs determined to be Type A programs. OMB Circular A-133, section 520(b)(3), states that—

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.

Step 2—Identify Low-risk Type A Programs

Section 520(c) of OMB Circular A-133 requires the auditor to identify Type A programs that are low-risk. Before a Type A program can be considered low-risk, it must first meet both of the following criteria:

- 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).

- No audit findings were identified in the most recent audit or a determination by the auditor that the findings do not keep the program from being considered low-risk. (Certain findings, such as significant deficiencies in internal control and material noncompliance, keep the program from being considered low-risk. Other findings, whether or not they keep the program from being considered low-risk is left to the judgment of the auditor. Such decisions should be documented.)

The auditor needs to apply professional judgment to determine whether a Type A program is low-risk. Although a Type A program cannot be low-risk if there were significant deficiencies in internal control or material noncompliance, other findings may not keep it from being considered low-risk. Paragraph 8.12 of the GAS/A-133 AICPA Audit Guide explains that a Type A program may be considered low-risk even if (a) findings included known or likely questioned costs greater than \$10,000 for a type of compliance requirement, (b) known fraud was identified, or (c) the summary schedule of prior audit findings materially misrepresents the status of a prior audit finding. In making the final determination of whether a Type A program is low-risk, the auditor should also consider the various risk criteria of the program, the results of audit follow-up, and whether any changes in personnel or systems affecting a Type A program have significantly increased its risk. However, Paragraph 8.11 of the GAS/A-133 AICPA Audit Guide remind auditors that their judgment “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 [Section 510 of OMB Circular A-133].”

In addition, federal agencies, with OMB approval, may designate programs that may not be considered low-risk. For example, such designation may be necessary to comply with legal requirements, such as the Government Management Reform Act of 1994. The federal agency is responsible for notifying entities receiving awards under such programs (and their auditors, if known) at least 180 days before the end of the fiscal year being audited.

American Recovery and Reinvestment Act Consideration. In 2009, the OMB designated programs with expenditures of Recovery Act funds as “higher risk.” Appendix VII of the March 2009 Compliance Supplement states “the auditor should consider all Federal programs with expenditures of [Recovery Act] awards to be programs of higher risk in accordance with § __.525(c)(2) and § __.525(d) of OMB Circular A-133.” Appendix VII further explains that this includes Type A programs that might otherwise be considered low risk under section 520(c)(1) of OMB Circular A-133, “except when the auditor determines, and clearly documents the reasons, that the expenditures . . . [are] low-risk for the program.”

Step 3—Identify High-risk Type B Programs

Similar to Step 2, auditors should use professional judgment and the federal program risk criteria discussed earlier to identify high-risk Type B programs. If the auditor elects option 1 as described at Step 4, all Type B programs exceeding the threshold described in the Circular must be assessed. However, if the auditor selects Option 2 under Step 4, the auditor may limit the identification of high-risk Type B programs to the number of low-risk Type A programs. OMB Circular A-133, section 520(d), states—

. . . except for known significant deficiencies in internal control or compliance problems [including management’s adherence to applicable laws and regulations and the provisions of contract and grant agreements, prior audit findings, and oversight exercised by granting entities], a single [federal program risk] criteria . . . would seldom cause a Type B program to be considered high-risk.

Small Program Exception. Section 520(d)(2) permits the auditor to exclude relatively small federal programs from the risk analysis process. A Type B small program is determined based on the formulas presented in Exhibit 1-3, which are included in Section 520(d)(2) of the Circular.

Exhibit 1-3**Determining "Type B" Small Program Floor**

If Total Federal Awards Expended Are:	A "Type B" Small Program Floor Applies to Any Program with Federal Awards Expended That Exceed:
\$500,000 ^a to \$100 million	The larger of \$100,000 ^a or .3% (.003) of total federal awards expended
Above \$100 million	The larger of \$300,000 or .03% (.0003) of total federal awards expended

Note:

- ^a Although the single audit threshold was increased from \$300,000 to \$500,000, the threshold to be used for performing risk assessments on Type B programs has not been increased.

* * *

Because most small organizations do not expend more than \$100 million of federal awards, they will be in the first category of the formula. Thus, in most instances, risk assessments will not be required for programs with less than \$100,000 of federal awards expended.

Step 4—Determine Major Programs

Major programs should be determined using the results of the risk analysis performed in Steps 2 and 3. OMB Circular A-133, section 520(e), indicates that at a minimum, the following programs should be considered major programs:

- *Non Low-risk (i.e., High-risk) Type A Programs.* Section 520(e)(1) requires all Type A programs, except those identified as low-risk, be considered major programs.
- *High-risk Type B Programs.* Section 520(e)(2) requires Type B programs as identified under either of the following two options be considered major programs.
 - *Option 1.* At least one-half of the high-risk Type B programs identified in Step 3. However, the Circular establishes a cap that the number of high-risk Type B programs audited as major programs need not exceed the number of low-risk Type A programs.
 - *Option 2.* One high-risk Type B program for each Type A program identified as low-risk under Step 2.
- *Additional Programs, as Necessary, to Comply with the Percentage of Coverage Rule.*

Type A Three-year Requirement. Type A programs must be audited as major programs at least once every three years. The three-year requirement is based on the Section 520(c)(1) provision that a Type A program must have been audited as a major program in at least one of the two most recent audit periods to be considered low-risk. Thus, auditors may need to classify additional Type A programs as major programs for testing purposes.

Option 1 and the Type B Program Cap. Option 1 establishes a cap that the number of high-risk Type B programs audited as major programs need not exceed the number of low-risk Type A programs. Because of the cap, the number of major programs determined using the risk-based approach is not required to exceed the number of major programs determined using the traditional formula approach (i.e., Type A programs), except as may be necessary to meet the percentage of coverage rule. In addition, the auditor is only required to perform risk assessments on Type B programs that exceed a certain threshold (\$100,000 for most entities).

Option 2. While Option 2 at Step 4 may yield the same number of programs as Option 1, the results will vary based on the composition (i.e., number, risk status) of the programs. One of the advantages of Option 2 is that the auditor

is not required to perform a risk assessment on all (or those exceeding the small program cap) Type B programs. The auditor is not required to identify more high-risk Type B programs than the number of low-risk Type A programs. *It should also be noted that under Option 2, if there are no low-risk Type A programs (or no Type A programs), there is no requirement to perform a risk assessment for any Type B programs.*

Selecting Type B Programs. Type B programs are only audited as major programs if (a) they are determined to be high risk and are selected for testing under either Option 1 or 2 of Step 4, or (b) they must be considered major programs to meet the percentage of coverage rule. When selecting high-risk Type B programs to audit as major programs under either Option 1 or 2, Section 520(e)(2)(ii) encourages auditors to select different Type B programs to audit as major programs over time.

Percentage of Coverage Rule and Low-risk Auditee Exception

Federal programs with aggregate federal awards expended of at least 50% of total federal awards expended must be classified as major programs. However, this percentage can be reduced to 25% for entities that qualify as "low-risk auditees." Because of the percentage of coverage rule, auditors may be required to audit more programs as major than the number of Type A programs. The auditor is not required to justify the selection of particular programs to comply with the percentage of coverage rule. Factors that the auditor may want to consider when selecting additional major programs include the following:

- The auditor's knowledge of the programs.
- Whether the programs are included in the OMB Compliance Supplement.
- The size of the programs (since larger programs will provide more coverage under the percentage of coverage rule, but may not be as efficient to audit).
- Whether future audit burden can be eased by selecting from low-risk Type A programs that must be audited as major programs at least every three years.
- Any auditee requests that particular programs be selected as major programs.

The preamble to OMB Circular A-133 clarifies several issues relating to the percentage of coverage rule. Specifically, it states that the amount of federal awards expended for loan and loan guarantee programs that are audited as major programs may be used to meet the percentage of coverage rule. In addition, any programs audited as major because of special grantor requests should also be considered when computing federal awards expended under the percentage of coverage rule.

The percentage of total federal awards expended may be reduced from 50% to 25% for entities that qualify as low-risk auditees. For all auditees, auditors must still select major programs as indicated in Step 4 or according to the rules for implementing the first year audit exemption. The auditor may not elect to treat programs meeting the major program criteria as nonmajor simply because the appropriate percentage of coverage has been met. Consider the following example:

Assume that after completing Steps 1–3 of the risk based approach, the auditor has classified an entity's programs as follows:

<u>Programs</u>	<u>Type</u>	<u>Risk Classification</u>	<u>Federal Expenditures</u>
1	A	Low-risk	\$ 2,425,000
2	A	Non low-risk (high-risk)	2,000,000
3	A	Non low-risk (high-risk)	1,600,000
4	A	Low-risk	1,300,000
5	B	Low-risk	275,000
6	B	High-risk	160,000
7	B	Low-risk	130,000
8	B	Low-risk	110,000
			<u>\$ 8,000,000</u>

Non low-risk auditee. If the entity is not a low-risk auditee, at least 50% of total federal expenditures must be classified as major programs. Using the criteria in Step 4, the auditor would select programs 2, 3, and 6 as major programs, which provides a 47% (\$3,760,000/\$8,000,000) percentage of coverage of total federal expenditures. As a result, the auditor would have to select one or more additional programs to meet the 50% threshold.

Low-risk auditee. If the entity is a low-risk auditee, only 25% of total federal expenditures must be classified as major programs. Similar to above, using the criteria in Step 4, the auditor would select programs 2, 3, and 6 as major programs, which provides a 47% (\$3,760,000/\$8,000,000) percentage of coverage of total federal expenditures. Considering the reduced coverage percentage (25%) for low-risk auditees and selection of programs 2, 3, and 6 as major programs using Step 4, the auditor would not need to select any additional programs as major programs. Even though the percentage of coverage exceeds the 25% expenditure threshold for major programs, the auditor may not elect to treat programs meeting the major program criteria as nonmajor (that is, may not “de-select” major programs) simply because the appropriate percentage of coverage has been met.

Special Grantor Requests

The granting agency may require other programs to be audited as major programs in lieu of the agency conducting or arranging for additional audits. If the program would not have been audited otherwise as a major program, and the requesting agency agrees to pay the full incremental costs, the entity should have the program audited as a major program.

First Year Audit Exemption

In a first year audit engagement, the auditor may elect to determine major programs as all Type A programs plus any Type B programs necessary to reach the percentage of coverage rule. According to OMB Circular A-133, Section 520(i) and Paragraph 9.20 of the GAS/A-133 AICPA Audit Guide, this first year audit exemption from use of the risk criteria applies to the first year an entity has an audit in accordance with the Circular A-133 or the first year after a change in auditors. However, the exemption may not be used by an entity more than once in every three years to ensure that a frequent change of auditors would not preclude the audit of high-risk Type B programs. Thus, it may be necessary for a successor auditor to communicate with the predecessor auditor to determine if the exception is available.

In engagements where the auditee plans to change auditors within two years, the client may wish to reserve the exemption for use by the successor auditor. (While, it is generally an election the auditor makes, the client may arrange with the present auditor to elect use of the risk-based approach.) Due to their experience with the client, it would generally be easier for the existing auditor to implement the risk-based approach. This situation is expected to be more common with governmental units due to requirements for rotation of outside auditors.

Low-risk Auditees

Criteria for a Low-risk Auditee. To be eligible for a reduced threshold for testing (i.e., 25% of total federal awards expended tested as major programs instead of 50%), an entity must qualify as a “low-risk auditee.” An entity is considered a low-risk auditee if it meets *all* of the following criteria, specified in OMB Circular A-133, Section 530, for *each* of the previous two years (or, in the case of biennial audits, the previous two audit periods):

- Single audits were performed on an annual basis. An 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.
- 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 grant a waiver if they determine the management of federal awards is not affected by the opinion qualification.
- No material weaknesses in internal control, as defined by the Yellow Book, were identified. However, the cognizant or oversight agency may grant a waiver if they determine the management of federal awards is not affected by any identified material weaknesses.
- 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 internal controls over compliance.
 - Noncompliance with the provisions of laws, regulations, contracts, or grant agreements that had a material effect on the Type A programs.
 - Known or likely questioned costs which exceed 5% of the total federal awards expended for a Type A program during the year.

If the entity only has Type B programs (and no Type A programs) for each of the previous two years, the last criterion in the preceding paragraph would not be applicable. Thus, an entity with only Type B programs could qualify as a low-risk auditee if it meets the first three criteria. In addition, only the cognizant or oversight agency for audit may provide the waivers identified in the low-risk auditee criteria. A pass-through entity may not provide a low-risk waiver to a subrecipient.

In some instances, whether an auditee qualifies as a low risk auditee does not affect the determination of major programs because the results of Steps 1–4 identify sufficient major programs to meet the higher 50% (versus 25% for low-risk auditees) percentage of coverage rule. However, OMB representatives have indicated that it is still necessary to determine whether the auditee meets the low-risk auditee criteria to comply with several reporting requirements. The first section of the schedule of findings and questioned costs requires a statement as to whether the auditee “qualified as a low-risk auditee.” Also when completing the data collection form, the auditor, at Part III, item 3, must answer the question, “Did the auditee qualify as a low-risk auditee?” The only possible answers on the form are “Yes” or “No.” OMB representatives have indicated that the Federal Audit Clearinghouse has rejected data collection forms that answer this question “Did not make determination” or “Determination was not necessary.” As a result, it is believed it is necessary to determine whether the auditee meets the low-risk auditee criteria to comply with reporting requirements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following should be the auditor's first step to achieve the audit objectives?
 - a. Identify risks.
 - b. Develop the audit plan.
 - c. Prepare an audit strategy.
2. Which of the following statements regarding cognizant and oversight agencies for audit is most accurate?
 - a. The OMB Circular A-21 allows the reassignment of cognizance if both agencies provide substantial direct funding.
 - b. Recipients expending more than \$30 million per year in federal awards are required to have a designated cognizant agency for audit.
 - c. Advising the auditor is one responsibility of the cognizant agency for audit.
 - d. Once a reassignment has occurred, both the old and new cognizant agencies for audit have 90 days to notify the auditee.
3. OMB Circular A-133 provides that if an auditee does not have an assigned cognizant agency for audit the auditee will do which of the following?
 - a. Be under the general oversight of the federal agency.
 - b. Be required to have a risk-based audit approach.
 - c. Be required to identify low-risk type A programs.
4. Which of the following statements most accurately illustrates the communication process with the cognizant or oversight agency for audit?
 - a. Once a cognizant agency has been reassigned, it is the cognizant agency's responsibility to contact the auditor/auditee.
 - b. Cognizant agencies are required under SAS No. 109 to approve the audit scope in advance of the audit.
 - c. The cognizant or oversight agency for audit does not make the decision as to what office within an agency will be assigned to the organization.
 - d. An organization may only have one cognizant or oversight agency for audit at a time.
5. What can auditors achieve by choosing a risk-based approach to single audits?
 - a. Shifts the audit away from traditional major programs.
 - b. Concentrates on programs with large dollar expenditures.
 - c. Eliminates the need to determine the total of all grants supporting the program.

6. OMB Circular A-133 recommends that the auditor use a four-step process to determine major programs for the entity they are auditing. This process involves which of the following set of steps?
- a. Identify type A and B programs, identify cluster programs, identify low-risk type A programs, and identify high-risk type B programs.
 - b. Determine major programs, identifying high-risk type B programs, identify type A and type B programs, identifying low-risk type A programs.
 - c. Identify low-risk type A programs, determine planning materiality, identify high-risk type B programs identify low-risk type A programs.
 - d. Identify low-risk type A programs, identifying high-risk type B programs, identifying low-risk type B programs, identifying type A and type B programs.
7. Which of the following is **not** considered one of the four criteria specified in OMB Circular A-133 necessary for an entity to be considered a low-risk auditee?
- a. Single audits must be performed on an annual basis.
 - b. No material weaknesses were identified.
 - c. The auditor's opinions on the financial statements were qualified.
 - d. No federal programs had audit findings of noncompliance with the provisions of laws.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following should be the auditor's first step to achieve the audit objectives? **(Page 116)**
 - a. Identify risks. [This answer is incorrect. The identification process is an overriding objective of the audit plan that should be used to assess if the risks could result in noncompliance or material misstatement.]
 - b. Develop the audit plan. [This answer is incorrect. The audit plan documents the timing, nature, and extent of procedures to be performed to obtain sufficient appropriate audit evidence. The development of an audit plan is also included in audit planning.]
 - c. **Prepare an audit strategy. [This answer is correct. Audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high-level description of the audit scope. The audit strategy consists of identifying material locations and account balances; and identifying audits areas with increased risk of material misstatement.]**
2. Which of the following statements regarding cognizant and oversight agencies for audit is most accurate? **(Page 119)**
 - a. The OMB Circular A-21 allows the reassignment of cognizance if both agencies provide substantial direct funding. [This answer is incorrect. The revisions to OMB Circular A-21 assigns cost negotiation cognizance for educational institutions to specific federal agencies contingent upon certain criteria. The OMB Circular A-133 permits the federal awarding agency with cognizance for an auditee to reassign cognizance to a different federal awarding agency only if both agencies provide substantial direct funding and consents to be the cognizant agency for audit.]
 - b. Recipients expending more than \$30 million per year in federal awards are required to have a designated cognizant agency for audit. [This answer is incorrect. Any agency expending more than \$50 million per year will have a designated cognizant agency for audit.]
 - c. **Advising the auditor is one responsibility of the cognizant agency for audit. [This answer is correct. This is just one of several responsibilities of a cognizant agency for audit. When suitable, advise the auditor and auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor.]**
 - d. Once a reassignment has occurred, both the old and new cognizant agencies for audit have 90 days to notify the auditee. [This answer is incorrect. Both the old and new cognizant agencies have only 30 days to inform the auditee of any reassignments.]
3. OMB Circular A-133 provides that if an auditee does not have an assigned cognizant agency for audit the auditee will do which of the following? **(Page 121)**
 - a. **Be under the general oversight of the federal agency. [This answer is correct. The OMB has assigned cognizant agencies for audit for larger governmental and nonprofit entities. Section 400(b) of OMB Circular A-133 states that an auditee that does not have a designated cognizant agency for audit will be under the general oversight of the federal agency.]**
 - b. Be required to have a risk-based audit approach. [This answer is incorrect. The risk-based audit approach is used when determining which federal programs are major programs and does not relate to the assignment of a cognizant agency.]
 - c. Be required to identify low-risk type A programs. [This answer is incorrect. Identification of low-risk type A programs is an audit requirement of OMB Circular A-133 and is not impacted by the entity not having an assigned cognizant agency for audit.]

4. Which of the following statements most accurately illustrates the communication process with the cognizant or oversight agency for audit? **(Page 122)**
- a. **Once a cognizant agency has been reassigned, it is the cognizant agency's responsibility to contact the auditor/auditee. [This answer is correct. The cognizant agency is instructed to contact the auditor and/or auditee within 30 days of any reassignment.]**
 - b. Cognizant agencies are required under SAS No. 109 to approve the audit scope in advance of the audit. [This answer is incorrect. According to Paragraph 6.38 of the GAS/A-133 AICPA Audit Guide, neither the cognizant or oversight agency for audit is required to approve the audit scope or plan in advance of the audit; but states that auditors may communicate with the cognizant or oversight agency for audit to assist in planning the audit.]
 - c. The cognizant or oversight agency for audit does not make the decision as to what office within an agency will be assigned to the organization. [This answer is incorrect. Oversight is being the responsibility of the cognizant, oversight agency for audit, program officials or audit officials.]
 - d. An organization may only have one cognizant or oversight agency for audit at a time. [This answer is incorrect. Organizations may have a cognizant agency for audit at the state level and a cognizant or oversight agency for audit at the federal level.]
5. What can auditors achieve by choosing a risk-based approach to single audits? **(Page 124)**
- a. **Focuses on programs with a higher risk of noncompliance. [This answer is correct. It is the auditor's responsibility to identify major programs. OMB Circular A-133, Section 520 prescribes the risk-based approach that determines which federal programs are considered major programs. Thus, by adopting the risk-based approach, the can focus on programs that have a higher risk of noncompliance occurring to an emphasis on programs that exhibit signs of managerial weakness or are inherently risky by nature.]**
 - b. Concentrates on programs with large dollar expenditures. [This answer is incorrect. Traditional major programs are those with large dollar expenditures.]
 - c. Eliminates the need to determine the total of all grants supporting the program. [This answer is incorrect. The total of all grants are, not separate awards, and must be determined before applying the risk-based approach.]
6. OMB Circular A-133 recommends that the auditor use a four-step process to determine major programs for the entity they are auditing. This process involves which of the following set of steps? **(Page 126)**
- a. Identify type A and B programs, identify cluster programs, identify low-risk type A programs, and identify high-risk type B programs. [This answer is incorrect. Identifying cluster programs are part of the definition of federal programs, but are not one of the fours steps for determining major programs.]
 - b. **Determine major programs, identifying high-risk type B programs, identify type A and type B programs, identifying low-risk type A programs. [This answer is correct. These are the four steps recommended by OMB Circular A-133 to determine major programs.]**
 - c. Identify low-risk type A programs, determine planning materiality, identify high-risk type B programs identify low-risk type A programs. [This answer is incorrect. Determining planning materiality relates to planning the audit but is not a step recommend by OMB A-133 in determining materiality.]
 - d. Identify low-risk type A programs, identifying high-risk type B programs, identifying low-risk type B programs, identifying type A and type B programs. [This answer is incorrect. Identifying low-risk type B programs is not one of the four steps recommended by OMB Circular A-133 in determining major programs. Low-risk type B programs are not part of the identification process.]

7. Which of the following is **not** considered one of the four criteria specified in OMB Circular A-133 necessary for an entity to be considered a low-risk auditee? **(Page 131)**
- a. Single audits must be performed on an annual basis. [This answer is incorrect. One of the criterions includes that single audits were performed on an annual basis. Any entities that have biennial audits do not qualify as low-risk. The only exception is if agreed upon in advance by the cognizant or oversight agency for audit.]
 - b. No material weaknesses were identified. [This answer is incorrect. Generally, as defined by the Yellow Book, if material weaknesses in internal control have been identified, an entity cannot be considered a low-risk auditee. However, the oversight or cognizant agency may issue a waiver if they conclude the management of federal awards is not affected by any identified material weaknesses.]
 - c. **The auditor's opinions on the financial statements were qualified. [This answer is correct. One of the four criteria specified in OMB Circular A-133 is that the auditor's opinions on the schedule of expenditures of federal awards and financial statements are unqualified. However, a waiver may be granted by the cognizant or oversight agency if they determine that the management of federal awards is not affected by the opinion qualification.]**
 - d. No federal programs had audit findings of noncompliance with the provisions of laws. [This answer is incorrect. One of the four criteria in OMB Circular A-133 states that no federal programs can have audit findings from noncompliance with provisions of laws, regulations, contracts, or grant agreements that have a material effect on the Type A programs.]

STATE AND LOCAL GRANT COMPLIANCE REQUIREMENTS

In addition to the requirements of the Single Audit Act Amendments and OMB Circular A-133 that are imposed on entities that expend specified amounts of federal awards during a year, entities that receive and/or expend state or local grants may be subject to additional requirements imposed by the state or local grantor agency.

Different Models for Audit Requirements

Generally, state governments prescribe audit requirements under one of the following three models:

- a. *Single Audit.* The state requires the performance of a single audit.
- b. *Individual Grant Audits.* The state requires that each grant be audited individually. Individual grantor agencies determine and implement the specific audit requirements.
- c. *Individual Agency Audits.* Audit requirements are not set by the state, but are specified by the individual grantor agencies. For some grants, audit requirements may not exist.

Some cities and large municipal governments also use similar models to prescribe audit requirements. In recent years, however, an increasing number of grantors have adopted a single audit approach to increase audit efficiency.

Effect of State or Local Grant Requirements on the Audit of Financial Statements

When planning the audit of the financial statements, the auditor should obtain an understanding of state or local grant requirements and consider those that have a direct and material effect on the financial statements. To become familiar with state or local grant requirements, the auditor should—

- Inquire of management about sources of revenue received by the entity and about restrictions, limitations, terms, or conditions related to the revenue.
- Review any agreements related to the revenues and amounts expended.
- Inquire of management or the grantor agency about compliance and reporting requirements related to the revenue.

The audit divisions of sponsoring agencies usually can be helpful in identifying compliance and reporting requirements. These requirements may be published in an audit guide or identified separately for each recipient.

Performing an Audit of State or Local Grant Activity

If the auditor is engaged to perform an audit of state or local grant activity, including an audit of compliance with grant requirements, the auditor should determine the nature of the audit requirements (e.g., a single audit, an individual grant audit, or an individual agency audit) and consider the relationship of the audit requirements to any federal audit requirements. In addition, the auditor should determine the nature of funding for audit costs. *Under OMB Circular A-133, the cost of state or local audit requirements that go beyond federal requirements cannot be paid from federal awards.*

In determining the nature of audit requirements, Paragraph 6.40 of the GAS/A-133 AICPA Audit Guide indicates that auditors might consider performing the following procedures:

- 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, etc.) relating to the grant.
- Read the grant agreements and any amendments, including referenced laws and regulations.
- Review information about governmental audit requirements 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.

If any applicable audit guidance, including audit guides, is obtained from the grantor agency or oversight agency, the auditor should also confirm with the grantor agency that any applicable audit guides expected to be used contain all administrative rulings and amendments pertaining to the grant.

In instances where state (or local) awards must be subjected to single audit procedures, auditors should give careful consideration to determination of major programs. Major programs for federal (including pass-through) grants should be determined based solely on federal awards as defined in the Single Audit Act Amendments and OMB Circular A-133. The auditor should coordinate with the state grantor agency to determine the appropriate method of defining the threshold for the testing of state programs.

Reporting Requirements—Grantor Agency Variations

Grantor agencies often substitute reporting forms different from those that would be required in an audit in accordance with the Yellow Book or a single audit. Reports in addition to an audit report on financial statements are usually required on the same areas (i.e., financial data, internal control, and compliance with laws and regulations), but the form of report may differ from those specified in federal guidelines.

Reports on Compliance with Laws and Regulations. The grantor agency's requirements may prescribe a form of report on compliance with laws and regulations that is different from the reports prescribed by the Yellow Book. In that case, the auditor needs to consider whether the form of assurance required by the grantor agency is appropriate. The auditor should be careful not to issue a report that provides more assurance than is warranted by the scope of the audit. SAS No. 74 applies to governments and nonprofit organizations that are subject to the Single Audit Act Amendments or the Yellow Book. If the organization is not subject to the Single Audit Act Amendments, OMB Circular A-133, or the Yellow Book, SSAE No. 10 (AT 601, *Compliance Attestation*), is applicable for these engagements. AT 601 provides guidance to auditors who are requested to issue a report on an entity's compliance with laws and regulations. The Statement provides guidance for performing agreed-upon procedures and examination engagements and for preparing the different types of reports for each type of engagement.

Reports on Internal Control. The form of report on internal control prescribed by the Yellow Book may be appropriate, but grantor agencies frequently require a different form of report. Some agencies may require a report that includes an *opinion* on internal control. SSAE No. 15 (AT 501, *An Examination of an Entity's Internal Control Over Financial Reporting That is Integrated With an Audit of Its Financial Statements*) provides guidance to auditors who perform an examination of the design and operating effectiveness of internal control over financial reporting in the context of an integrated audit (an audit of the entity's financial statements and an examination of its internal control). An integrated audit is planned and performed to achieve the objective of both engagements.

AT 501 is not applicable to (1) an examination of only the suitability of the design of internal controls, (2) an examination of controls over the effectiveness and efficiency of operations, (3) an examination of controls over compliance with laws and regulations, (4) an engagement to report on controls of a service organization, or (5) an engagement to perform agreed-upon procedures on controls. Some granting agencies may require a report on internal controls over compliance with laws and regulations. The auditor should refer to AT 601 for guidance on agreed-upon procedures engagements when requested to report on management's written assertions regarding the effectiveness of the internal controls over compliance with laws and regulations.

Federal Pass-through Awards

Organizations often receive combined pass-through awards. Combined pass-through awards include a portion of federal funding and a portion of nonfederal funding that is awarded by the state or other organization. The nonfederal funds should not be confused with federal awards as they are not subject to the requirements of OMB Circular A-133. The total amount should be included in the schedule and a note to the schedule should describe the commingled nature of the funds. In addition, the GAS/A-133 AICPA Audit Guide, Paragraph 11.36, states that when a pass-through entity is unable to identify amounts passed through to subrecipients, the auditor should consider (a) whether a significant deficiency (and possibly a material weakness) should be reported and (b) whether material noncompliance (for subrecipient monitoring) should be reported.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Which of the following audit models grant requirements are **not** set by the state?
 - a. Individual agency audit.
 - b. Single audit.
 - c. Individual grant audits.
9. Which of the following statements is most accurate when reporting on compliance with laws and regulations?
 - a. If the grantor agency's requirement prescribes a report on compliance with laws and regulations that is different from the Yellow Book, the auditor should consider the report appropriate.
 - b. Auditors should not issue reports that provide more assurance than is necessary by the scope of the audit.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. Which of the following audit models grant requirements are **not** set by the state? **(Page 138)**
 - a. **Individual agency audit. [This answer is correct. The individual agency audit is just one of three models state governments prescribe for audit requirements. Under the individual agency audits, audit requirements are not arranged by the state. These are specified by the individual grantor agencies.]**
 - b. Single audit. [This answer is incorrect. The performance of a single audit is a requirement of the state.]
 - c. Individual grant audits. [This answer is incorrect. The specific audit requirements are determined by the individual grantor agencies and are required by the state to be individually audited.]
9. Which of the following statements is most accurate when reporting on compliance with laws and regulations? **(Page 139)**
 - a. If the grantor agency's requirement prescribes a report on compliance with laws and regulations that is different from the Yellow Book, the auditor should consider the report appropriate. [This answer is incorrect. The grantor agency's requirements may prescribe a form of report on compliance with laws and regulations that is different from the reports prescribed by the Yellow Book. In that case, the auditor needs to consider whether the form of assurance required by the grantor agency is appropriate.]
 - b. **Auditors should not issue reports that provide more assurance than is necessary by the scope of the audit. [This answer is correct. The auditor should be careful not to issue a report that provides more assurance than is warranted by the scope of the audit.]**

RISK ASSESSMENT AND OTHER PLANNING PROCEDURES

An overriding objective throughout the planning process is the consideration of risks that should be assessed and whether they could result in material misstatement of the financial statements or material noncompliance. SAS No. 106 clearly indicates the role of the risk assessment procedures in planning as follows:

The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels.

Assessing Risk of Noncompliance

As part of assessing the risks of material misstatement, the auditor should assess the risk that noncompliance might cause a material misstatement of the financial statements and design the audit to provide reasonable assurance of detecting such noncompliance. Paragraph 3.18 of the GAS/A-133 AICPA Audit Guide states that in considering whether noncompliance might cause the financial statements to be materially misstated, the auditor should:

- Assess whether management has identified compliance requirements that have a direct and material effect on the determination of financial statement amounts.
- Obtain an understanding of the possible financial statement effects of those compliance requirements.
- Assess the risk that instances of noncompliance have caused a material misstatement of the financial statements.
- Design and perform the audit to provide reasonable assurance of detecting such material noncompliance.

The GAS/A-133 AICPA Audit Guide, Paragraph 3.19, identifies the following procedures the auditor might perform to assess management's identification of compliance requirements and obtain an understanding of their possible financial statement effects:

- Consider information about compliance requirements obtained in prior audits.
- Discuss the compliance requirements with the entity's chief financial officer, legal counsel, or grant administrators.
- Obtain written representation about the completeness of management's identification of compliance requirements.
- Review the relevant parts of directly related agreements, such as grant and debt agreements.
- Identify sources of revenue, review related agreements, and inquire about governmental regulations on accounting for the revenue.
- Obtain publications related to compliance requirements, such as those that address federal tax and other reporting requirements (e.g., Department of Treasury and IRS requirements for information returns or that address arbitrage rebates and refunds).
- Obtain copies of laws and regulations affecting the entity, including federal and state constitutions, articles of incorporation, charters, and bylaws. Review relevant sections, as applicable, such as those which address financial reporting, investments, budget, and appropriation and procurement matters.
- Review minutes of governing body meetings for enactment of laws and regulations or information about contracts and grant agreements that have a direct and material effect on the financial statements.
- Inquire of IGs, state auditors, or local auditors or other appropriate oversight organizations about applicable compliance requirements, including statutes and uniform reporting requirements.

- Review information about applicable federal and state compliance requirements, such as information in the OMB Circular A-133 Compliance Supplement, the Catalog of Federal Domestic Assistance, federal audit guides, and state and local policies and procedures.
- Review guidance in applicable AICPA Audit and Accounting Guides and in content available from other professional organizations, such as state CPA societies or industry associations.
- Inquire of grantor audit, finance, or program administrators about grant restrictions, limitations, terms, and conditions.

To understand the possible financial statement effects of compliance requirements, it might help to consider:

- The likelihood of noncompliance occurring.
- Whether the financial statement effect is quantitatively or qualitatively material.
- The level of personnel (e.g., management, employee) involved in the compliance-assurance process.
- Whether there is an opportunity for noncompliance to be concealed.

In assessing the risk of material noncompliance in a single or program-specific audit, Paragraph 6.28 of the GAS/AICPA Audit Guide states that the auditor should:

- Identify risks and related controls when obtaining an understanding of the entity and its environment.
- Relate the identified risks to what can go wrong at the relevant compliance requirement level.
- Consider whether the likelihood and magnitude of the risks could result in noncompliance with requirements that have a direct and material effect on one or more major programs.

Significant Risks

The auditor should determine which of the risks identified by risk assessment procedures are risks that require special audit consideration. The AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (AICPA Risk Assessment Audit Guide), indicates that one or more significant risks normally arise on most audits and that significant risks “are likely to exist even in those situations where there are no new or unusual circumstances at the client.” The AICPA Risk Assessment Audit Guide further notes, in Paragraph 5.29, that a significant risk is “one where the inherent risk is higher than the usual ‘high’ and therefore it requires special audit consideration.” The auditor should determine whether the risk is such that it requires special audit consideration by focusing on the following:

- The nature of the risk.
- The magnitude of the potential misstatement, including the possibility of multiple misstatements.
- The likelihood of the risk occurring.

Each of these aspects of the auditor’s consideration needs attention in determining whether special audit consideration is required, but the nature of the risk is particularly important.

The nature of the risk should be evaluated by considering the following:

- Is the risk a risk of fraud?
- Is the risk related to recent significant economic, accounting, or other developments?
- Are the transactions complex?

- Does the risk involve significant transactions with related parties?
- Is there a relatively large degree of subjectivity in the measurement of the financial information related to the risk?
- Does the risk involve significant nonroutine transactions outside the normal course of business or that otherwise appear unusual?
- Hypothetically, if the auditor had a time constraint to perform the audit, would the risk be one that would absolutely need to be addressed through substantive tests of details?

An affirmative answer to any of these questions is likely to indicate the need for a specific audit response and, thus, a determination that the risk is a significant risk because it requires special audit consideration. Risks of material misstatement or noncompliance due to fraud are always significant risks. Risks of material misstatement or noncompliance due to error also may be deemed significant risks depending on their nature. In determining significant risks, it is helpful to consider the degree of inherent risk. The AICPA Risk Assessment Audit Guide suggests that it may be helpful to compare all high inherent risks to each other to assist with the identification of significant risks.

Examples of matters that often involve significant risks include the following:

- Significant nonroutine transactions, that is, transactions that are unusual due to their size or nature.
- Accounting estimates for which there is significant measurement uncertainty.
- Transactions that involve complex calculations or the application of complex accounting principles.
- Significant related party transactions.
- Transactions that require a large degree of manual intervention in data collection and processing.
- Unusual or infrequent transactions that by their nature make effective controls difficult to implement, such as major litigation.
- Transactions that involve a relatively large degree of management intervention in specifying the accounting treatment.

The identification of risks as significant risks has important implications for further audit procedures, including tests of controls. Once the auditor has identified the risk as a significant risk, the auditor should do the following:

- To the extent the auditor has not already done so, evaluate the design of the related controls, including relevant control activities, and determine whether they have been implemented. (AU 314.115)
- If the auditor plans to rely on the operating effectiveness of controls intended to mitigate the significant risk, perform tests of controls in the current period. Reliance on evidence from tests of controls performed in prior periods is not permitted. (AU 318.45)
- Perform substantive procedures that are specifically responsive to the risk. (AU 318.53)
- If the auditor does not plan to rely on the controls and is performing only substantive procedures, the substantive procedures should be tests of details only or a combination of tests of details and substantive analytical procedures. Use of only substantive analytical procedures is not permitted. (AU 318.54)
- Document the significant risks identified and related controls evaluated. (AU 314.122)

In determining the appropriate audit response to significant risks, the auditor considers his or her understanding of the relevant controls, including control activities. The most effective audit approach may depend on whether management has identified the risk and responded by designing and implementing effective controls.

Obtaining an understanding of the entity and its environment, including its internal control, is an essential aspect of the consideration of risk. In a single audit or program-specific audit, it is also essential to understand the entity's federal award programs and compliance requirements, and its internal control over compliance with those requirements. Auditing standards refer to the audit procedures performed to obtain that understanding as *risk assessment procedures*.

Assessment Procedures

Types of Risk Assessment Procedures. The risk assessment and other planning procedures required by SAS Nos. 108 and 109 to obtain information about the entity and its environment, including its internal control, and to assess the risks of material misstatement include the following:

- a. Preliminary engagement activities, including establishing an understanding with the client.
- b. Inquiries of management and others.
- c. Preliminary analytical procedures.
- d. Observation and inspection, such as visits to the entity's premises and tracing transactions through the information system (that is, walkthroughs).
- e. Discussion among the engagement team.

SAS No. 109 requires the auditor to perform the procedures specified in items b.–d. when obtaining an understanding of the entity and its environment. There is no requirement that each of those procedures be performed for every component of the required understanding outlined in the following section. However, the standards are explicit in indicating that inquiry alone is not sufficient to evaluate the design and implementation of internal control. Therefore, observation and inspection will most likely be coupled with inquiry procedures when obtaining the understanding of internal control.

Nature, Timing, and Extent—General Considerations. The nature, timing, and extent of some risk assessment procedures may be relatively consistent across audit engagements, but some procedures will require tailoring in response to the information gathered. For example, in all audits the auditor will make inquiries of management responsible for financial reporting about accounting policies and other aspects of the financial reporting process. However, determining others within the entity to whom related questions may be directed will depend on the circumstances and the specific information gathered about the entity. Thus, performance of risk assessment procedures often can begin without extended consideration of their nature, timing, and extent, but other aspects of the risk assessment procedures can only be determined after some information is gathered about the entity and its environment.

Gathering Other Information Needed to Identify Fraud Risks. The GAS/A-133 AICPA Audit Guide, Paragraph 6.25, states that the auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. In connection with obtaining an understanding of the entity's environment, auditor may become aware of information that is relevant to identifying fraud risks. In addition, the auditor should perform the following procedures to obtain information that is used to identify fraud risks:

- Inquire of management and others about the risks of fraud and how they are addressed.
- Consider the results of preliminary analytical procedures.
- Consider the existence of fraud risk factors.
- Consider certain other information, such as identified inherent risks, and information resulting from the discussion among engagement team members, client acceptance and continuance procedures, and reviews of interim financial statements, program financial reports, and other reports.

Using the Results of Risk Assessment Procedures Performed in Prior Periods. Because professional standards require the performance of risk assessment procedures to obtain an understanding of the entity and provide a basis for the assessment of risks, can the auditor use information gathered from procedures performed in a prior period and limit the extent of current year procedures? The answer is a qualified “yes.”

The process of understanding the governmental client's operations and environment is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit. The auditor's previous experience with the entity also contributes to the understanding of the entity and its environment. Audit procedures performed in previous audits ordinarily provide useful audit evidence about the following:

- The entity's organizational structure, federal award programs, operations, and controls.
- Past misstatements and noncompliance and whether they were corrected on a timely basis.

Information about past misstatements and noncompliance assists the auditor in assessing risks of material misstatement in the current audit. Before using information obtained in prior periods, however, the auditor should determine whether changes have occurred that may affect its relevance in the current audit. According to SAS No. 109, “The auditor should make inquiries and perform other appropriate audit procedures, such as walkthroughs of systems, to determine whether changes have occurred that may affect the relevance of such information.”

Inquiries of Management and Others

Inquiry of management and others is used extensively throughout the audit planning process. In many cases, it serves as a foundation for the performance of other risk assessment procedures in that the responses obtained drive the need for additional or corroborating procedures. The auditor should inquire of management about the following matters:

- a. The aspects of the entity and its environment as enumerated in SAS No. 109.
- b. The information about fraud, suspected fraud, fraud-related programs and controls, and risks of fraud as enumerated in SAS No. 99.

The auditor might decide that inquiries of others within and outside the entity, in addition to management and those responsible for financial reporting, would be useful. Examples of inquiries that might be made of others include the following:

- a. *Those Charged with Governance.* Their involvement in the financial reporting process and how the financial statements are used. (SAS No. 99, AU 316.22, requires the auditor to inquire directly of the audit committee, or at least its chair, about the risks of fraud and knowledge of fraud or suspected fraud.) Many governmental units have established an audit committee or similar group.
- b. *Internal Audit.* Activities concerning the design and effectiveness of internal control and management's responses to any findings by the internal audit function. (SAS No. 99, AU 316.23, requires inquiry of internal audit personnel about risks of fraud, knowledge of fraud or suspected fraud, and activities concerning fraud detection.)
- c. *Other Employees.* Their role in the financial reporting process and additional or corroborating information to support management's responses. (SAS No. 99, AU 316.24, requires inquiry of others within the entity, determined through the auditor's judgment, about the existence or suspicion of fraud.) Auditors may consider obtaining the perspective of employees from different functional areas and at varying levels of authority when identifying risks of material misstatement. Examples of inquiries that may be made of other employees include:
 - (1) *Financial Reporting Personnel.* Appropriateness of the selection and application of accounting policies, including the initiation, authorization, processing, or recording of complex or unusual transactions. (SAS No. 99, AU 316.58, explicitly requires inquiries about knowledge of inappropriate or unusual activity relating to the processing of journal entries and other adjustments.)

- (2) *In-house Legal Counsel.* Litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud, and the meaning of contract terms.
- (3) *IT Systems Users.* Their role in identifying changes to IT systems, how frequently changes occur, effectiveness of application and access controls, and excessive system downtime and other functional issues.
- d. *Parties Outside the Entity.* Inquiries of parties outside the entity are not required but are procedures that might be helpful. For example, the auditor might find it useful to make inquiries of external legal counsel or of valuation experts, if any, that management has engaged.

Additional Government Auditing Standards Requirements. *Government Auditing Standards* require auditors to make inquiries about findings and recommendations from previous engagements and evaluate whether appropriate corrective actions have been taken to address findings that could have a material effect on the financial statements. The Yellow Book, at Paragraph 4.09, states that auditors should ask management “to identify previous audits, attestation engagements, and other studies that directly relate to the objectives of the audit, including whether related recommendations have been implemented.” Auditors are required to use this information when assessing risk and determining the nature, timing, and extent of audit work, including the testing of implementation of corrective actions.

Fraud-related Inquiries. As part of gathering the information needed to identify fraud risks, auditors should inquire of management and others about—

- Their knowledge of any actual fraud or suspicions of fraud affecting the entity, including major federal award programs.
- Their awareness of any allegations of fraud or suspected fraud affecting the entity, including major federal award programs.
- Their understanding of the risks of fraud within the entity, including any specific fraud risks the entity has identified or account balances or transaction classes that may be susceptible to fraud.
- How they communicate to employees the importance of ethical behavior and appropriate operating practices.
- Programs and controls the entity has implemented to address identified fraud risks or otherwise help prevent, deter, and detect fraud and how those programs and controls are monitored.
- The nature and extent of monitoring multiple locations or components and whether any of them have a higher level of fraud risk.
- Whether they have reported to those charged with governance about how the internal control serves to prevent, deter, and detect material misstatements due to fraud.

Documentation. SAS No. 109 (AU 314.122) requires documentation of risk assessment procedures performed in obtaining an understanding of the entity and its environment. The requirements are applicable to all audits performed under *Government Auditing Standards*, including single and program-specific audits. The form and extent of the auditor’s documentation will depend on the nature, size, and complexity of the entity and its environment (including its internal control), the availability of information from the entity, and the specific audit methodology and technology used in obtaining the understanding. AU 314.123 indicates that documentation of the auditor’s work should generally be more extensive when the auditor performs more extensive audit procedures and when the entity and its environment are more complex.

Preliminary Analytical Procedures

SAS No. 56 (AU 329.04) states that analytical procedures should be applied to some extent in all audits of financial statements to assist the auditor in planning the nature, timing, and extent of other auditing procedures. To

accomplish this, SAS No. 56 (AU 329.06) indicates that analytical procedures used in planning the audit should focus on—

- a. Enhancing the auditor's understanding of the client's operations and the transactions and events that have occurred since the last audit date.
- b. Identifying areas that may represent specific risks relevant to the audit.

Knowledge of the entity and the environment in which it operates is interrelated with the use of analytical procedures in audit planning. Performing effective preliminary analytical procedures requires the auditor to understand the entity's operations and to know what relationships would be expected to exist, what relationships would be considered unusual or unlikely, and what plausible explanations might exist for observed relationships. That knowledge is also important in assessing the significance of differences from expected relationships. For that reason, the auditor generally needs an understanding of the entity's operations before performing preliminary analytical procedures.

Other than the analytical procedures performed to comply with SAS No. 99, analytical procedures used in the planning stage only need to be designed to point out audit areas that may be indicative of potential risks and, thus, need special emphasis.

Analytical Procedures Related to Revenue. In addition to the requirement for preliminary analytical procedures in SAS No. 56, SAS No. 99 specifically requires auditors to perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting.

Documentation. Documentation of preliminary analytical procedures can be limited, but it should be sufficient to provide support for the auditor's risk assessment. The results of the preliminary analytical review ordinarily are documented using a narrative memorandum, comparative carryforward schedule, or other form of workpaper. Documentation may also include the effect on the audit plan or indicate that the results should be considered when identifying fraud risks.

Observation and Inspection

Observation and inspection procedures are required when obtaining an understanding of the entity and its environment, including its internal control, to assess risk. There are a number of ways to use observation and inspection when assessing risk. When obtaining an understanding of the entity and its environment, observation or inspection might be the key procedure that enables the auditor to fully obtain pertinent information and identify related risks. For example, in order to gain an understanding of the client's federal award programs and underlying compliance requirements, the auditor would review the client's grant agreements and other related documents.

More frequently, observation and inspection are used to corroborate or follow-up on the results of inquiries made of management and others. For example, when evaluating the design and implementation of the entity's system of internal control, members of management might tell the auditor that they communicate the importance of ethical values to employees through a written code of conduct and by example. The auditor might wish to corroborate this response by examining the written code. In addition, the auditor may determine that a risk exists based on observation of management's current and past interactions with employees that contradict the behavior standards in the written code.

Documentation. SAS No. 109 requires documentation of risk assessment procedures performed in obtaining an understanding of the entity and its environment. It is recommended that auditors adopt the following:

- For an inspection of documents, identify the item inspected, for example, by indicating the title and date of the report or the document name and number.
- For an observation procedure, document the process or subject matter observed, individuals involved and their titles, and where and when the observation was carried out.

Discussion among the Engagement Team

SAS No. 109 (AU 314.14), requires the members of the audit team to discuss the susceptibility of the entity's financial statements to material misstatements. SAS No. 99 (AU 316.14) requires an exchange of ideas, or "brainstorming" among audit team members about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. These discussions can be held concurrently, that is, one meeting can cover the susceptibility of the financial statements to material misstatements from both error and fraud. The focus of the audit team discussion should be on the individual members gaining a better understanding of the potential for material misstatements resulting from error or fraud in the specific areas assigned to them, and understanding how the results of audit procedures they perform affect other aspects of the audit. In this discussion, the more experienced members of the audit team can share their insights based on their cumulative knowledge of the entity and its environment.

Matters to be Discussed. This discussion is aimed at the susceptibility of the financial statements to material misstatement, that is, the areas of vulnerability. The discussion is one of the sources of information used to assess the risks of material misstatement. Thus, the discussion should not be a narrow one focused on risks already identified, but one that opens the minds of members of the audit team to potential material misstatements from error and, particularly, from fraud. Any high risk areas that have already been identified, however, should be communicated to the team members. Among other matters, SAS No. 109 indicates that the discussion should include the following:

- a. Critical issues and areas of significant audit risk.
- b. Areas susceptible to management override of controls.
- c. Unusual accounting practices used by the client.
- d. Application of GAAP to the entity's facts and circumstances in light of its accounting policies.
- e. Important control systems.
- f. Materiality at the financial statement level (planning materiality) and at the account level (tolerable misstatement).
- g. How materiality will be used to determine the extent of testing.
- h. The need to exercise professional skepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred, and to be rigorous in following up on such indications.

Examples of other factors that affect the likelihood of material misstatements caused by error that the engagement team might discuss include the following:

- Past experience with the client.
- Changes in the client's organization (for example, changes in personnel or accounting systems).
- The nature and complexity of transactions.
- Known accounting and auditing issues.

In addition to discussing important control systems, it may be appropriate to discuss potential risks that may exist due to limitations in the client's personnel and assignment of responsibilities. For some smaller entities, the engagement team might consider issues regarding the background and competence of individuals in key processing and financial decision-making roles, especially if concerns had been noted in previous audits.

Discussion about Fraud. SAS No. 99 indicates that the discussion should include the following fraud-related matters:

- How and where the entity's financial statements (for example, which accounts or transaction classes) might be susceptible to material misstatement due to fraud.
- How management could perpetrate and conceal fraudulent financial reporting.
- How the entity's assets could be stolen.
- External and internal factors that might create incentives/pressures, provide opportunities, or enable rationalization of fraud.

Discussion about Noncompliance. In addition to discussing the susceptibility of the financial statements to material misstatement, the engagement team might also discuss the susceptibility of major programs to material noncompliance with compliance requirements. This discussion could be held separately from the general planning meeting if single audit planning is done at a later date.

Documentation. SAS No. 109 requires that the following items be documented regarding the discussion among the audit team:

- How and when the discussion occurred.
- Subject matter discussed.
- Participating audit team members.
- Significant decisions reached concerning planned responses at the financial statement and relevant assertion levels.

These requirements are similar to the documentation requirements of SAS No. 99 regarding the fraud-related discussion among the audit team.

In a single or program-specific audit, the auditor should also document the discussion among the engagement team regarding:

- The susceptibility of the major programs to direct and material noncompliance with compliance requirements.
- Significant decisions reached concerning planned responses to compliance requirements.

Other Risk Considerations

Considering Risk of Material Misstatement Due to Errors and Fraud. SAS No. 1 (AU Section 110, *Responsibilities and Functions of the Independent Auditor*) explains the auditor's responsibility to detect material misstatements caused by errors or fraud. SAS No. 1, as amended, (AU 110.02) states, "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." The SAS does not prescribe any specific audit procedures to be applied. However, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, requires auditors to identify and assess risks of material misstatement of the financial statements due to fraud and prescribes certain specific procedures that should be applied. The auditor is expected to fulfill the responsibility of designing the audit to provide reasonable assurance of detection by exercising due care in planning, performing, and evaluating the results of audit procedures and by exercising the proper degree of professional skepticism. The exercise of due care and professional skepticism depends heavily on an effective assessment of the risk of material misstatement.

Considering Risk of Material Misstatement Due to Illegal Acts. The AICPA's Professional Issues Task Force issued Practice Alert 2004-1, *Illegal Acts*, which provides guidance to auditors performing a financial statement audit regarding possible illegal acts by a client. It indicates that the auditor's responsibility to detect and report misstatements from illegal acts having a direct and material effect on the financial statements is the same as that caused by error or fraud, including assessing the risk that an illegal act may cause the financial statements to contain a material misstatement. The audit should be designed to provide reasonable assurance that such illegal acts will be detected.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. Sallie Mae is conducting an audit of Edwards & Maine. What benefit would Sallie Mae achieve by using results of risk assessment procedures performed in prior periods?
 - a. A clearer understanding of the entity's organization structure, controls and operations.
 - b. The scope of services to be provided.
 - c. Identification of federal and major programs.
 - d. Insight to fraud and suspected fraud.
11. When should the results of the preliminary analytical procedures be documented?
 - a. When planning the current year engagement.
 - b. When unusual relationships that should be considered in identifying risks of material misstatements are revealed.
12. The firm of Young, Micah, & Sweet, has accepted the services of Andy Auditing, Inc. to perform a single audit. The Andy Auditing team decides to discuss the susceptibility of the firm's financial statements to material misstatements. Which guidance is the Andy Auditing team following?
 - a. SAS No. 74.
 - b. SAS No. 99.
 - c. SAS No. 107.
 - d. SAS No. 109.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. Sallie Mae is conducting an audit of Edwards & Maine. What benefit would Sallie Mae achieve by using results of risk assessment procedures performed in prior periods? **(Page 147)**
- a. **A clearer understanding of the entity's organization structure, controls and operations. [This answer is correct. The method of understanding the governmental client's environment and operations is constant. By understanding an entity's organizational structure, operations, and controls; as well as the past misstatements and if they were corrected on a timely basis can provide the auditor with useful information reading the current audit.]**
 - b. The scope of services to be provided. [This answer is incorrect. Determining the scope of services to be provided is an activity that should be performed before the planning activities in a single audit engagement begins.]
 - c. Identification of federal and major programs. [This answer is incorrect. This information usually is discussed during the planning meeting.]
 - d. Insight to fraud and suspected fraud. [This answer is incorrect. Inquiries about fraud and suspected fraud should be made to management extensively throughout the audit.]
11. When should the results of the preliminary analytical procedures be documented? **(Page 149)**
- a. When planning the current year engagement. [This answer is incorrect. The effect of unresolved prior-year findings should be evaluated when planning the current-year engagement.]
 - b. **When unusual relationships that should be considered in identifying risks of material misstatements are revealed. [This answer is correct. If analytical procedures do not identify possible risks of misstatement, documentation is limited to signing off that step on the auditing program. However, if while conducting an audit, unusual or unexpected relationships that should be considered in identifying risks of misstatement are revealed, the results should be documented using a narrative memorandum.]**
12. The firm of Young, Micah, & Sweet, has accepted the services of Andy Auditing, Inc. to perform a single audit. The Andy Auditing team decides to discuss the susceptibility of the firm's financial statements to material misstatements. Which guidance is the Andy Auditing team following? **(Page 150)**
- a. SAS No. 74. [This answer is incorrect. According to SAS No. 74, the auditor's primary focus when designing the audit should be to provide reasonable assurance that the financial statements are free of material misstatement resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.]
 - b. SAS No. 99. [This answer is incorrect. The exchange of brainstorming and ideas is a requirement of SAS No. 99.]
 - c. SAS No. 107. [This answer is incorrect. SAS No. 107 requires the auditor to make a preliminary judgment about materiality for the financial statements taken as a whole.]
 - d. **SAS No. 109. [This answer is correct. According to SAS No. 109, auditors must document and discuss the susceptibility of the entity's financial statements to material misstatements.]**

UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

SAS No. 109 (AU 314) requires the auditor to obtain a sufficient understanding of the entity and its environment, including its internal control, to assess 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. This concept also applies in a single audit. It is necessary for the auditor to obtain an understanding of the entity and its federal award programs, including internal control over compliance related to those programs, to assess the risk of material noncompliance, and to design the nature, timing, and extent of further compliance audit procedures.

OMB Circular A-133 requires grant recipients to maintain internal control over compliance for federal award programs that provides reasonable assurance federal awards are managed in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each program. The auditor is required to perform procedures to obtain an understanding of internal control over compliance that is sufficient to plan the audit to support a low assessed level of control risk for major programs. To do so, the auditor needs to understand the assertions relevant to the compliance requirements for each major program. In obtaining this understanding, the auditor obtains an understanding of both the design of relevant controls pertaining to each of the five internal control components (i.e., control environment, risk assessment, control activities, information and communication, and monitoring) and whether they have been placed in operation.

Because OMB Circular A-133 requires the auditor to determine whether the recipient has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each major federal program, the auditor should assess not only the risk that noncompliance may cause a material misstatement of the financial statements, but also the risk that noncompliance may have a material effect on each major program.

As indicated in the previous paragraph, the general planning in a single audit engagement usually begins with obtaining a knowledge and understanding of the client's environment, including its internal control. The auditor's focus in obtaining the understanding should be on obtaining knowledge sufficient to develop an audit plan, including identifying significant audit areas, to assess the risk of material misstatement of the financial statements due to error or fraud, to assess the risk of material noncompliance with laws, regulations, and the provisions of contracts or grant agreements relevant to major federal award programs, and to design further audit procedures.

Components of the Understanding

The auditor's understanding of the entity and its environment consists of an understanding of the following items:

- a. Industry, regulatory, and other external factors.
- b. Nature of the entity.
- c. Objectives, strategies, and related risks.
- d. Measurement and review of federal award program performance.
- e. Internal control.

As part of understanding the entity and its environment, the auditor obtains an understanding of the entity's selection and application of accounting policies. The selection and application of accounting policies is considered an aspect of internal control, but is presented separately in this discussion because of its significance to the auditor's assessment of the risks of material misstatement. Similarly, the consideration of fraud risk factors is an important objective of performing risk assessment procedures. Although considering the presence of fraud risk factors occurs simultaneously with obtaining information about the entity and its environment, it merits separate and focused attention.

Documentation. SAS No. 109 (AU 314.122) indicates that auditors should document the following:

- Key elements of the understanding obtained for each of the aspects of the entity and its environment to assess the risks of material misstatement.

- Sources of the information from which the understanding was obtained.
- Risk assessment procedures that were performed.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, requires auditors to document their consideration of fraud risk factors.

Industry, Regulatory, and Other External Factors

The auditor should obtain an understanding of industry, regulatory, and other external factors relevant to the audit. The objective of the auditor's understanding is to evaluate whether the entity is subject to specific risks of material misstatement arising from the nature of the industry, degree of regulation or other external forces, such as political, economic, social, or technological forces. The following discussion highlights such matters that are particularly relevant for a single audit.

Risk Assessment Procedures and Factors to Consider. In most single audits, the auditor will initially gather information and identify risks related to industry, regulatory, and other external factors through inquiry of client management and other employees. Depending upon the responses received, it may be necessary for the auditor to expand the inquiries to more fully understand the area and follow up on information that may indicate a potential risk.

The auditor might supplement inquiry procedures with inspection or other risk assessment procedures. For example, the auditor might read correspondence from regulatory authorities, applicable regulations that were recently enacted, or recent AICPA audit and accounting guides.

Funding Sources and Legal Requirements. The auditor should inquire of management and read pertinent statutes, regulations, bylaws, and charter provisions and excerpt significant items for the permanent file section of the workpapers. Federal or state regulations or various funding source requirements may have an important influence on the entity's operations, control activities, or accounting system. The budgetary process and related requirements are particularly important. Also, the relationship of state and local laws to federal laws and single audit requirements may be important. If any legal requirements need clarification, the auditor should request a written interpretation from the client's legal counsel.

The client is responsible for the preparation of the schedule of expenditures of federal awards. The requirement to present a schedule of expenditures of federal awards means that the organization must identify all of its federal programs (direct and indirect) and related awards expended. Early preparation of the schedule facilitates the planning process by identifying all of the federal award programs. The programs must be identified before the auditor can (a) determine whether a single audit is required, (b) begin the risk analysis process, and (c) determine major programs for testing.

SAS No. 74 (AU 801.06) indicates that "... the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts." In addition, for a single audit, the auditor must design the audit to provide reasonable assurance of detecting instances of noncompliance with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each major program. Thus, in planning the audit, the auditor needs to obtain an understanding of the possible effects of such laws, regulations, and the provisions of contracts or grant agreements on the entity's financial statements and on the entity's major programs. SAS No. 74 suggests procedures that the auditor should consider performing to obtain such an understanding.

Political Environment. Knowledge and understanding of the political environment is particularly important in a single audit engagement. Political considerations include both general and specific matters that may have an influence on the conduct of the engagement. The auditor should consider the public interest and reaction to expenditures that may be viewed by the average citizen as waste, misuse, or abuse of governmental or nonprofit resources even if the associated expenditures are not material, e.g., first class airfare, extravagant entertainment expenses or excessive salary levels, etc. In addition, for a governmental unit, the auditor should consider the dynamics of the local political scene. Is there a taxpayer initiative to limit or restrict certain types of taxes? Has a new

administration promised to reduce taxes and still balance the budget? Such political considerations may motivate questionable accounting practices.

Economic Environment. Because governmental units and nonprofit organizations are often very sensitive to economic changes, the auditor should consider both general and local economic trends and consider the potential effects on the engagement. A downturn in the economy can put governmental and nonprofit organizations under severe financial pressure. Some entities may cut costs and reduce activities. Others may attempt to develop new funding sources. This need to economize may lead to the elimination or weakening of existing controls. These various responses can affect the audit areas considered to be key areas as well as the risk of particular types of misstatements.

Reporting Requirements. The auditor should inquire of management and review grant requirements, bond covenants, requirements of higher levels of government (e.g., state, county, etc.), and pertinent statutes to identify the legal reporting requirements of the governmental or nonprofit organization. In a governmental or nonprofit engagement, legal reporting requirements may include requirements for both financial and nonfinancial information. In addition, a single audit requires additional reporting on internal control and on compliance with laws, regulations, and the provisions of contracts or grant agreements as well as a report on the schedule of expenditures of federal awards.

Nature of the Entity

The auditor should obtain an understanding of the nature of the entity relevant to the audit. The nature of the entity that needs to be considered in a governmental or nonprofit single audit engagement includes the entity's structure and governance and the operations related to major federal award programs. Matters that the auditor might consider are discussed in the following paragraphs.

Structure and Governance Characteristics. There may be conflicting pressures that can affect the organizational structure and governance of the governmental or nonprofit organization, which can affect the nature, timing, and extent of audit procedures. On one hand, scrutiny by outside parties and externally imposed audit and compliance requirements may influence management control consciousness and result in better controls than typically found in a private business of similar size. However, the combination of part-time or relatively unknowledgeable administrators and employees may result in a poor control environment and increased risk of material misstatement and noncompliance with laws and regulations. The effects of these characteristics must be considered for the particular organization in assessing the risk of material misstatement and the risk of material noncompliance.

The structure and governance of a governmental unit or nonprofit organization are affected by the allocation of administrative responsibilities. Often auditors maintain a permanent file memorandum discussing organizational matters that is updated as necessary. When considering administrative responsibilities, the auditor should focus on who really makes the decisions, how the decisions are made, and what methods are used to communicate decisions.

Audit Committees. Many governmental units and not-for-profit organizations have established a group of individuals formally designated with oversight of financial reporting, such as an audit committee. Auditors should determine whether there is such a group to which inquiries should be directed and communications made. *Government Auditing Standards*, as well as several AICPA Statements on Auditing Standards, have established requirements for auditor communication with groups or individuals responsible for oversight of financial reporting.

Operating Characteristics. The sources of grant funds and the related expenditures of the organization can have a critical effect on the nature, extent, and timing of audit procedures and the overall audit approach. Based on inquiry, observation, and reading of relevant contracts, grant agreements, and other agreements, the auditor should obtain an understanding of and document the operating characteristics of the organization's federal programs. In particular, the auditor should identify the departments, agencies, and locations where major programs are administered. In addition, the auditor should determine where records related to major programs are maintained. The auditor also should obtain an understanding of procedures over indirect costs and cost allocation plans and procedures for monitoring subrecipients.

During the planning stages of the engagement, the auditor of a pass-through entity should obtain copies of all available subrecipient audit reports. If subrecipient audits have not been completed as of the end of fieldwork and

the amount of funds awarded to subrecipients is material, consideration should be given to expanding the scope of the pass-through entity's audit to include testing of the subrecipient. Audit of subrecipients, however, is not a required part of the pass-through entity's audit. Auditors should be aware of any amendments to subrecipient agreements and monitoring procedures. Such monitoring procedures may include limited scope engagements, which can be more targeted and less costly than an audit performed in accordance with OMB Circular A-133.

Risk Assessment Procedures and Factors to Consider. Similar to the understanding of the activity, regulatory, and other external factors, the auditor initially makes inquiries of appropriate client personnel about the nature of the entity and its federal award programs. To make effective inquiries, it is critical that the auditor identify the right person within the entity that possesses not only the requisite knowledge about the subject matter of the inquiry, but also about the nature of risks, how the entity has addressed them and what the remaining risk is to the entity. In a small governmental unit or nonprofit organization, the executive director may be able to answer most inquiries. In a larger entity, the auditor may need to make inquiries of several individuals.

Objectives, Strategies, and Related Risks

The auditor should obtain an understanding of the entity's objectives, strategies, and operating risks related to federal award programs. The basic concept here is that most risks eventually have financial or compliance consequences and, thus, impact the single audit. Not all operating risks create risks of material misstatement or noncompliance, so the auditor needs to focus on risks that have implications in the entity's particular circumstances.

The auditor obtains an understanding of management's objectives and strategies to identify the operating risks. Management and those charged with governance determine the objectives which are the overall plans for the entity's federal award programs. Management's strategies are the operational approaches adopted to achieve the objectives. The related operating risks are the significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve the objectives or implement the strategies.

Risk Assessment Procedures and Factors to Consider. When obtaining an understanding of management's objectives and strategies to identify the operating risks related to the federal award programs, the risk assessment procedures employed by the auditor may be influenced by the size and sophistication of the client. When making inquiries, the auditor will generally restrict questioning to upper management of the entity given the subject matter and the level of knowledge that is needed to sufficiently address it. These inquiries would prompt management to describe the entity's expectations, objectives, and strategies.

Measurement and Review of Federal Award Program Performance

The auditor should obtain an understanding of the measurement and review of federal award program performance made by management and external parties. Information used by management for measurement and review relevant to a single audit might include program, grant, or other internally prepared reports or reports received from grantors or regulatory agencies.

Performance measures can affect the audit and the auditor's assessment of the risks of material misstatement or noncompliance in several ways, including the following:

- a. The pressure to meet performance targets or comply with grant requirements could motivate management actions, including intentional misstatements, and, thus, affect the auditor's risk assessment.
- b. Use of performance measures might highlight unexpected results or trends, which upon investigation result in detection of misstatements or noncompliance.

Risk Assessment Procedures and Factors to Consider. The procedures used by the auditor for understanding the measurement and review of federal award program performance will often be driven by the size and sophistication of the entity. Management may have identified key performance indicators that it uses when managing the program. As management reviews reports, a determination is made whether the entity has achieved the targets that management has established for these indicators. For these situations, the auditor would likely use inquiry to determine what indicators management believes are important in managing and measuring the entity's results along with the reports that are used to monitor performance and compliance.

For all situations, the auditor should consider inquiring whether there is any external measurement of the federal award program performance. If so, the auditor may review available reports to identify potential risks.

Selection and Application of Accounting Policies

The auditor should obtain an understanding of management's selection and application of accounting policies and evaluate whether the policies are appropriate for the entity's activities and consistent with policies used in federal award program reporting. This understanding is important for considering the risks of material misstatement or noncompliance. The auditor's assessment of the appropriateness of the accounting policies that management has selected and applied is an important element in determining what can go wrong in the preparation of financial statements (or the schedule of expenditures of federal awards) and, hence, in assessing risks of material misstatement/noncompliance.

Accounting policies include the accounting principles as prescribed by relevant accounting pronouncements as well as the methods adopted to apply those principles in the circumstances. The auditor's understanding of management's selection and application of accounting policies includes the following:

- a. Relevant accounting pronouncements and specific governmental and nonprofit accounting practices.
- b. The methods the entity uses to account for significant and unusual transactions.
- c. Changes in the entity's policies, including the reasons for the change and whether the change is appropriate and consistent with GAAP (or an OCBOA).
- d. Reporting standards and requirements that are new to the entity and management's plans to adopt such requirements, including new accounting pronouncements or regulatory requirements.
- e. The process used by management in formulating particularly sensitive accounting estimates.
- f. The methods used to identify matters for disclosure and how the entity achieves clarity in disclosure.

Risk Assessment Procedures. The nature and extent of the risk assessment procedures to obtain an understanding of the selection and application of accounting policies normally depend on factors such as—

- The auditor's knowledge and experience with the governmental or nonprofit industry and single audits.
- The auditor's past experience with the particular entity.
- The degree of financial reporting sophistication of the financial management of the entity.
- The extent of new accounting standards that are recently effective for the entity.
- The auditor's participation in assisting with the selection of accounting policies and the preparation of the financial statements or schedule of expenditures of federal awards.

For many small entities, the auditor is instrumental in both selecting accounting principles and recommending the methods by which they are applied. Consideration of accounting policies for those clients ordinarily will not be a time-consuming process because the auditor already possesses much of the requisite knowledge. The auditor in those cases can generally confine inquiries of the client to matters such as the manner and consistency of application.

Fraud Risk Factors

When obtaining information about the entity and its environment, the auditor should consider whether the information indicates that fraud risk factors are present. Fraud risk factors are conditions or events that indicate incentives/pressure to perpetuate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Fraud risk factors may be related to fraudulent financial reporting or misappropriation of assets.

The identification of fraud risk factors is a natural by-product of performing risk assessment procedures. Along with the other information obtained about the entity and its environment, the fraud risk factors are an important component in identifying the risks of material misstatement or noncompliance. The auditor's primary concern in considering fraud risk factors is to identify whether a risk factor *is present and should be considered in identifying and assessing risks of material misstatement or material noncompliance due to fraud*. The presence of a particular fraud risk factor does not necessarily indicate the existence of fraud. Whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement or material noncompliance due to fraud is a matter of professional judgment.

Auditor's Considerations of Fraud Risk Factors. For misappropriation of assets, the consideration of fraud risk factors is influenced by the degree to which assets susceptible to misappropriation are present. However, some consideration should be given to risk factors related to incentives/pressures, opportunities arising from control deficiencies, and attitudes/rationalizations for misappropriation, even if assets susceptible to misappropriation are not material. When considering risk factors for misappropriation, the auditor may identify risk factors related to inadequate monitoring and weaknesses in internal control that could also be present when fraudulent financial reporting occurs.

If fraud risks are present, SAS No. 109, (AU 314.12), states that "the auditor should consider whether the assessment of the risk of material misstatement due to fraud calls for an overall response, one that is specific to a particular account balance, class of transaction, or disclosure at the relevant assertion level, or both." An overall response is considered in establishing the overall audit strategy and a specific response is considered in developing the detailed audit plan.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. Which of the following statements is most accurate regarding the structure and governance characteristics of an entity?
 - a. How the administrative responsibilities are distributed can affect the governance of a governmental unit.
 - b. Generally, management is not affected by scrutiny from outside parties.
 - c. An organization risks the possibility of an increased risk of material misstatement with laws and regulations when using new employees.
14. What is the primary influence on the consideration of fraud risk factors in regards to misappropriation of assets?
 - a. The conduct of the engagement.
 - b. The size and sophistication of the client.
 - c. The extent to which assets susceptible to misappropriation exist.
 - d. The entity's operations and accounting system.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. Which of the following statements is most accurate regarding the structure and governance characteristics of an entity? **(Page 157)**
- a. **How the administrative responsibilities are distributed can affect the governance of a governmental unit. [This answer is correct. The distribution or allocation of administrative responsibilities can affect the structure and governance of a governmental unit or nonprofit organization. In this case, the auditor should focus on those individuals who make the decisions, how the decisions are made, and what methods are used to communicate those decisions.]**
 - b. Generally, management is not affected by scrutiny from outside parties. [This answer is incorrect. Scrutiny from outside parties can influence management's control consciousness and result in better controls than normally found in other private organizations of similar size.]
 - c. An organization risks the possibility of an increased risk of material misstatement with laws and regulations when using new employees. [This answer is incorrect. The combination of part-time or unknowledgeable administrators and employees may result in a poor control environment and an increased risk of material misstatement and noncompliance with laws and regulations.]
14. What is the primary influence on the consideration of fraud risk factors in regards to misappropriation of assets? **(Page 160)**
- a. The conduct of the engagement. [This answer is incorrect. The conduct of the engagement usually is influenced by the entity's environment.]
 - b. The size and sophistication of the client. [This answer is incorrect. When obtaining an understanding of management's objectives and strategies to identify the operating risks related to the federal award programs, the risk assessment procedures employed by the auditor may be influenced by the size and sophistication of the client. However, this is not the primary influence.]
 - c. **The extent to which assets susceptible to misappropriation exist. [This answer is correct. The degree to which the presence of assets is susceptible to misappropriation exists highly influences the consideration of fraud risk factors in regards to misappropriation of assets. Also, other factors to consider include factors related to incentives/pressures, and opportunities arising from control deficiencies.]**
 - d. The entity's operations and accounting system. [This answer is incorrect. An entity's operations, control activities, and accounting system can be influenced by federal or state regulations. However, this is not the primary influence.]

PLANNING DECISIONS AND JUDGMENTS

The information the auditor gathers about the entity and its environment, including its federal award programs, by performing risk assessment procedures is used to make several important planning decisions and judgments. The primary planning decisions and judgments relative to a single audit are (a) materiality and tolerable noncompliance, (b) the risks of material misstatement/noncompliance, (c) the overall audit strategy, and (d) the specific nature, timing, and extent of further audit procedures.

The GAS/A-133 AICPA Audit Guide, Paragraph 10.05, states that planning (as well as conducting and evaluating) compliance testing in a single audit requires the auditor to exercise professional judgment. It provides the following factors that the auditor might consider:

- The assessment of audit risk.
- The assessment of materiality.
- The evidence obtained from other auditing procedures.
- The amount and diversity or homogeneity of program expenditures.
- The length of time that the program has operated.
- Changes in the program's conditions.
- Current and prior auditing experience with the program, especially findings in previous audits and other evaluations (such as inspections, program reviews, or system reviews).
- The extent to which the program is conducted by subrecipients and related monitoring activities.
- The extent to which the program contracts for goods or services.
- The level of program reviews or other forms of independent oversight.
- The expectation of compliance or noncompliance with the direct and material compliance requirements.
- The extent to which computer processing is used to administer the program and the complexity of the processing.
- Whether the *OMB Circular A-133 Compliance Supplement* identifies the program as being higher risk.

Audit Risk and Materiality Are Considered Together

In a single audit, audit risk and materiality need to be considered together for each major program being tested and for each direct and material compliance requirement when determining the nature, timing, and extent of audit procedures and evaluating the results of those procedures.

Materiality

In a single audit, materiality should be determined for each major program taken as a whole, rather than for all major programs combined, and may be affected by several factors including compliance requirements that may be nonmonetary in nature. Paragraph 10.07 of the GAS/A-133 AICPA Audit Guide explains that materiality is affected by:

- the nature of the compliance requirements, which might not be quantifiable in monetary terms,
- the nature and frequency of noncompliance identified with an appropriate consideration of sampling risk, and
- qualitative considerations, such as the needs and expectations of federal agencies and pass-through entities.

The auditor has to plan the audit of federal award programs so that there is only a relatively low risk of failing to detect (a) misstatements that, when taken together, would cause the financial statements or schedule of expenditures of federal awards to be materially misstated and (b) noncompliance with requirements governing each major program that, when taken together, would be material to the program. The auditor's consideration of materiality for planning purposes is a qualitative consideration, and the auditor uses the preliminary judgment about materiality to make audit scope decisions. The consideration of materiality in a single audit differs from that in the audit of financial statements. In the audit of financial statements, the auditor considers materiality in relation to the financial statements being audited. However, when auditing compliance with requirements governing federal award programs, the auditor also considers materiality at the major program, compliance requirement, and audit finding levels. As discussed in the following paragraphs, the auditor's assessment of materiality for a specific instance of noncompliance will depend on the particular compliance requirement that is being evaluated.

Under OMB Circular A-133, there are several levels of materiality relating to the single audit:

- *Major program level*—materiality level for opining on the entity's compliance with requirements having a direct and material effect on each major program. [For clusters, materiality is based upon the cluster rather than the individual programs within the cluster.]
- *Compliance requirement level*—materiality level for individual compliance requirements.
- *Audit finding level*—materiality level for purposes of reporting audit findings in the schedule of findings and questioned costs. Audit finding materiality is defined in OMB Circular A-133, Section 510(a).

In addition, materiality for auditing compliance under GAAS and the Yellow Book is determined at the financial statement level.

Compliance requirement and audit finding materiality levels are lower levels of materiality than major program materiality. OMB Circular A-133 requires auditors to report material noncompliance with provisions of laws, regulations, contracts, or grant agreements related to a major program in the schedule of findings and questioned costs. Paragraph 6.31 of the GAS/A-133 AICPA Audit Guide indicates that "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 a major program or an audit objective identified in the . . . Compliance Supplement." For example, if a noncompliance relating to eligibility is discovered, the auditor should first decide if the instance of noncompliance is material to the eligibility type of compliance requirement for the major program (compliance requirement materiality level). If the noncompliance is material to the eligibility type of compliance requirement, it would be reported as a finding in the schedule of findings and questioned costs. In addition, the noncompliance would also be reported in the schedule if it meets the OMB Circular A-133 criteria for inclusion in the schedule of findings and questioned costs (audit finding materiality level), even if the noncompliance did not exceed the compliance requirement materiality level. Next, the auditor would assess whether the noncompliance is material, either individually or when aggregated with other noncompliance findings, to the major program as a whole (major program materiality level). If it is determined to be material to the program, the auditor would render a qualified or adverse opinion on compliance with respect to that major program. A single compliance requirement materiality may be determined for all applicable types of compliance requirements, or different levels may be determined for each (or groups of) compliance requirement(s).

Materiality for Purposes of Assessing Compliance with Compliance Requirements. OMB Circular A-133 requires the auditor to test and report on the entity's compliance with compliance requirements governing major programs. When testing compliance with compliance requirements governing major programs, the auditor should consider materiality in relation to each compliance requirement and each major program being audited.

For purposes of assessing compliance with laws and regulations, Paragraph 10.09 of the GAS/A-133 AICPA Audit Guide defines a "material instance of noncompliance" 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.

In determining whether a compliance finding is material, the auditor should give consideration to both qualitative and quantitative factors.

Because OMB Circular A-133 requires an opinion on compliance for *each* major program, when considering whether instances of noncompliance are material to a major program, the auditor should consider the type and nature of the instances of noncompliance (either individually or in the aggregate), as well as the actual and projected impact of noncompliance, on each major program in which noncompliance was detected. The concept of materiality when opining on the entity's compliance with requirements having a direct and material effect on each major program should be applied to each major program taken as a whole, rather than to each individual compliance requirement. An amount that is material to one major program may be considered immaterial to another major program. If the tests of compliance reveal material noncompliance at the program level, the auditor should consider the effect of this noncompliance on the financial statements.

Government Auditing Standards Requirements. The 2007 Yellow Book, Paragraph 4.26, explains that additional materiality considerations might apply when the audit is conducted under *Government Auditing Standards*. In Yellow Book financial audits, it may be appropriate to use lower materiality levels than in a GAAS audit because of the public accountability of governmental entities and entities receiving government funding, various legal or regulatory requirements, and the sensitivity of government programs.

Determining Materiality for the Single Audit. As discussed in the preceding paragraphs, when opining on compliance with requirements governing federal award programs, materiality is assessed at the major program level. As discussed in Paragraph 10.08 of the GAS/A-133 AICPA Audit Guide, materiality relates to each individual major program taken as a whole, rather than to all major programs combined. It is believed that, in most situations, using 5% of total program awards expended will result in an appropriate materiality amount. However, other factors may impact this decision, and the auditor should use his or her professional judgment in making this determination. Materiality for assessing compliance with a particular compliance requirement (compliance requirement materiality level) generally is less than major program level materiality to allow for the possibility of undetected noncompliance. Audit finding materiality is defined in OMB Circular A-133.

Calculation of Tolerable Noncompliance. The term "tolerable misstatement" is used in SAS No. 39 on audit sampling, but the concept of a misstatement or noncompliance that could be material to an account balance or federal award program is the same, so this course uses the term "tolerable noncompliance" for ease of expression. Tolerable noncompliance is the acceptable limit of noncompliance for individual programs. In this sense, it is a "cushion" that the auditor allows for the necessary imprecision in applying auditing procedures to detect noncompliance with requirements governing major programs (i.e., an allowance for undetected noncompliance). The two types of noncompliance the auditor must address when evaluating materiality in relation to a major program are—

- Known noncompliance.
- Likely noncompliance.

The term "known noncompliance" means noncompliance that the auditor detects when applying auditing procedures. During planning, it is necessary for the auditor to make an estimate of the amount of "known" noncompliance. This amount has to be considered during planning because, if it is significant, it reduces the auditor's allowance for undetected noncompliance. Also, the auditor needs to estimate or project the total noncompliance from sampling applications and certain analytical procedures.

Calculation of an Individually Significant Amount. Tolerable noncompliance is often used in practice to determine the amount that will be considered *individually significant* to a major program. The calculation of an individually significant amount is a useful planning tool in deciding the nature and extent of compliance procedures. As a rule of thumb, the auditor may use one-third of tolerable noncompliance as the individually significant amount. However, the auditor may choose any amount less than tolerable noncompliance in order to reduce the risk of material noncompliance of the remaining balance to an acceptable level. Generally, in a single audit, the auditor will apply audit procedures to all items equal to or larger than this amount.

Using Tolerable Noncompliance in a Single Audit. The tolerable noncompliance amount is used in making decisions about the nature, timing, or extent of compliance procedures for individual federal award programs and is used in making the following types of scope decisions:

- 100% testing.
- Analytical procedures.
- Sampling.

It should be noted that in making all of these scope decisions, tolerable noncompliance is not the sole consideration. The auditor's consideration of materiality should always be combined with a careful consideration of audit risk to design the most efficient and effective audit approach in the circumstances.

100% Testing. An efficient and effective audit approach in many circumstances is to identify individually significant amounts for 100% testing. An important efficiency consideration is whether tests of compliance have to be performed using audit sampling. Often an auditor can divide a population into individually significant items and remaining items, apply tests of compliance to 100% of the significant items, and omit tests of the remaining items. The key to determining whether this approach is appropriate is a careful consideration of materiality, audit risk, and the relationship of items or amounts tested to the account or program.

Tolerable noncompliance is a useful tool for identifying items that are individually significant because of their amount. Once the individually significant items have been identified and tested, the auditor then needs to decide whether the remaining items should be tested by sampling or by analytical procedures, or whether tests of the remaining items may be omitted entirely. Generally, if the total dollar amount of remaining items is less than tolerable noncompliance and the auditor assesses combined inherent risk and control risk (audit risk) for the remaining items as relatively low, tests of the remaining items may be omitted entirely.

Analytical Procedures. In circumstances when the amount of remaining items exceeds tolerable noncompliance or when the auditor assesses audit risk for the remaining items as moderate to high, the auditor may be able to use a combination of 100% testing and analytical procedures rather than sampling the remaining items. However, the nature of many specific compliance requirements related to federal award program expenditures are such that the auditor often obtains only minimal assurance from analytical review procedures. In evaluating whether analytical procedures provide adequate evidence for the remaining balance, the auditor should consider the risk of material noncompliance of the remaining balance and the effectiveness of those analytical procedures. The auditor needs to balance the persuasiveness of the audit evidence produced by analytical procedures with the assessment of the risk of material noncompliance of the remaining balance (i.e., the consideration of audit risk).

Sampling. When the remaining balance after consideration of individually significant items exceeds tolerable noncompliance and the auditor concludes that analytical procedures are not effective enough to reduce audit risk to a relatively low level, sampling is usually necessary.

Assessing Risks of Material Misstatement

Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion. It is a function of the risk that the financial statements are materially misstated and the risk that the auditor will not detect such material misstatement. In this sense, audit risk is the risk of material misstatement remaining in the financial statements after the audit. Audit risk cannot be precisely measured as a percentage; thus, consideration of audit risk is necessarily judgmental, not mathematical. The auditor must consider audit risk for the financial statements taken as a whole. When considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. (These risks are also referred to as *overall risks*.)

Responding to Risks at the Financial Statement Level. SAS No. 110 provides guidance to auditors when determining overall responses to address risks of material misstatement at the financial statement level. These responses may include the following:

- Emphasis to the audit team to use professional skepticism.

- Assigning staff with higher experience levels or specialized skills.
- Increasing the level of supervision.
- Using a greater degree of unpredictability in selecting audit procedures.
- Changing the nature, timing, and extent of substantive procedures (e.g., instead of interim testing shift testing to period end or modify the nature of audit procedures to obtain more persuasive evidence).

Because there is always at least one identified fraud risk (a risk of management override of controls), certain overall responses are required in every audit, as follows:

- The auditor should consider whether the personnel assigned to the engagement possess the necessary knowledge and skills.
- The auditor should consider whether the extent of supervision of personnel is appropriate.
- The auditor should consider the client's selection and application of accounting principles, especially in subjective areas.
- The auditor should incorporate an element of unpredictability in the selection of audit procedures from year to year.

Other overall responses may also be appropriate to address identified fraud risks.

In addition to being required to assess the risk of material misstatement at the financial statement level due to error or fraud, the auditor is also required to assess the risk of a material misstatement of the financial statements or schedule of expenditures due to noncompliance. The assessment of identified risks and selection of appropriate responses can be a more effective process if the identified risks are well-articulated. To assist in assessing risks and determining further audit procedures to be performed, the authors recommend that auditors be as specific as possible when describing risks. This course recommends that a well articulated risk describe—

- The cause of the risk.
- The account balance, class of transactions, or disclosure and how it may be affected (that is, overstatement or understatement).
- If a fraud risk, the type of risk (misappropriation of assets or fraudulent financial reporting).
- The relevant compliance requirement assertion (or that it is an overall risk at the financial statements, schedule of expenditures of federal awards, or major program level).

Documentation. SAS No. 109 (AU 314.122) requires the auditor to document the risk assessment procedures performed; the assessment of risks of material misstatement at the financial statement level and the relevant assertion level; and the basis for the assessment. The auditor also should document the assessment of risks of material misstatement of the schedule of expenditures of federal awards and the assessment of risks of material noncompliance, and the basis for those assessments. The auditor is also required by SAS No. 110 to document overall responses to such risks.

Assessment of Audit Risk in a Single Audit. In a Single Audit, the auditor is required to determine whether the recipient 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. Thus, when developing an audit plan for a Single Audit, the auditor should assess not only the risk that noncompliance may cause a material misstatement of the financial statements, but also the risk that noncompliance may have a material effect on each major program. The authors recommend that the engagement team discussion held at the beginning of the audit cover the susceptibility of the recipient's major programs to material noncompliance.

Components of Audit Risk. The GAS/A-133 AICPA Audit Guide, paragraph 6.22, explains that the components of audit risk for a Single Audit are defined as:

- a. *Inherent Risk.* The susceptibility of a major program's compliance requirements to material noncompliance, assuming there are no related controls.
- b. *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 recipient's internal control.
- c. *Fraud Risk.* The risk that intentional material noncompliance with a major program's compliance requirements could occur.
- d. *Detection Risk.* The risk that the auditor will not detect noncompliance that could be material.

Inherent Risk. When assessing inherent risk, the auditor might want to consider the following factors:

- The complexity of the compliance requirements and the length of time the recipient has been subject to them.
- The potential quantitative and qualitative effect of noncompliance.
- Prior experience with the recipient's compliance.

Control Risk. OMB Circular A-133 requires the auditor to plan the testing of internal control over compliance to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each 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.

Fraud Risk. The auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements due to fraud and should consider that assessment when designing audit procedures. Although SAS No. 99 (AU 316) does not apply to a compliance audit, the auditor may want to consider its guidance when planning and performing an audit of compliance with major program requirements.

Detection Risk. In determining an acceptable level of detection risk, the auditor considers the assessed inherent risk, control risk, and fraud risk, and the extent to which he or she wants to limit audit risk related to the major program. As assessed inherent risk, control risk, or fraud risk decreases, the acceptable level of detection risk increases. As a result, the auditor might be able to alter the nature, timing, and extent of compliance tests based on the assessments of inherent risk, control risk, and fraud risk.

Assessing the Risk of Material Noncompliance. The GAS/A-133 AICPA Audit Guide, Paragraph 6.28, explains that when assessing the risk of material noncompliance, the auditor should:

- Identify risks while obtaining an understanding of the entity and its environment, including controls related to the risks.
- Relate the identified risks to what could 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 a major program.
- Consider the likelihood that the risks could result in noncompliance with requirements that have a direct and material effect on a major program.

Establishing an Overall Audit Strategy

The auditor should develop an overall audit strategy. The audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high level determination of the audit approach. It includes the identifica-

tion of overall risks, the overall responses to those risks, and the general approach to each audit area as being substantive procedures or a combination of substantive procedures and tests of controls. An important factor in determining the audit strategy in a single audit is the requirement for the auditor to test compliance with laws, regulations, and the provisions of contracts and grant agreements.

SAS No. 108 (AU 311.14) provides that in establishing the overall audit strategy the auditor should do the following:

- a. Determine the characteristics of the engagement that define its scope.
- b. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of communications required.
- c. Consider the important factors that will determine the focus of the audit team's efforts.

Steps a. and b. above are relatively straightforward factual determinations of the information to be audited, reporting objectives, the overall timing of the audit, and the written and other communications that will be required. Step c. is the heart of determining the nature, timing, and extent of audit procedures that will be necessary. In establishing audit strategy, these matters are dealt with at a high level rather than at the detailed audit plan level, which describes the nature, timing, and extent of procedures at the relevant assertion level.

The overall audit strategy includes and is significantly influenced by the auditor's judgments about materiality and the risks of material misstatement at the financial statement level and of material noncompliance. Important aspects of overall audit strategy that determine the focus of the audit team's efforts generally include the following:

- Materiality considerations.
- Preliminary identification of areas where there may be higher risks of material misstatement or noncompliance, including those due to fraud.
- Effect of assessed risk of material misstatement/noncompliance.
- Evaluation by audit area of whether the auditor plans to obtain evidence regarding the operating effectiveness of internal control, i.e., whether the auditor plans to use substantive procedures alone or a combination of substantive procedures and tests of controls.
- Determination of the composition and deployment of the audit team, including the assignment of audit work to team members, especially the assignment of appropriately experienced team members to areas identified as having a higher risk of material misstatement/noncompliance.
- Determination of the extent of involvement of professionals possessing specialized skills.
- Additional emphasis on the use of professional skepticism.
- Determination of general aspects of the nature, timing, and extent of further audit procedures, such as performing testing at the balance sheet date rather than at an interim date.
- Identification of recent significant developments affecting the entity, its federal award programs, its financial reporting, or its legal or economic environment.
- Determination of areas where client assistance is expected to be minimal.

In developing the overall audit strategy the auditor should incorporate decisions and judgments about overall responses to the risks of material misstatement at the financial statement level and the risks of material noncompliance at the major program level. A key outcome of developing the strategy is the determination of resources necessary to perform the engagement including:

- *Personnel Resources for Specific Audit Areas.* This includes the assignment of experienced team members or the involvement of experts for high risk or complex areas as well as the amount of resources for specific audit areas, including the timing of the deployment of such resources.

- *Management and Supervision of Personnel.* This includes management and supervision considerations such as team briefing meetings, reviews by the partner and manager, and quality control reviews.

Effect of Information Technology (IT) on Audit Strategy. A client's computer system also can affect the audit strategy because it can affect the risk of material misstatement or material noncompliance, which influences the auditor's substantive procedures, and also can affect the availability and sufficiency of audit evidence, including the audit trail. In computerized financial reporting systems, much of the client's data is processed and stored only in electronic form. Thus, errors and fraud involving computer programs and files may be less obvious than misstatements in manual records. Also, data processing duties are often concentrated in one or two employees. Those factors can create a higher risk of material misstatement or material noncompliance. However, that risk may be reduced if the client uses only purchased software and simple applications.

In addition, when information is available only in electronic form, its competence and sufficiency as audit evidence usually depend on the effectiveness of controls over its accuracy and completeness. Accordingly, the risk of improper initiation or alteration of information may be greater if the information is available only in electronic form and controls are not operating effectively. For example, automated controls and processes may be overridden leaving little or no visible evidence of the intervention. In that case, the auditor should perform tests of controls to gather evidence for use in assessing control risk.

Before designing the audit plan, the auditor should consider whether the client's computer system provides a clear audit trail. If the system does not provide a clear trail for posting transactions to the general ledger, including journal entries, the auditor may need to change the nature of planned substantive procedures, such as testing items comprising year-end balances instead of activity for the period. The auditor also should consider the amount and type of available data when designing audit procedures. It may be necessary to time the tests based on when the accounting data is available. Data availability can be affected by both the computer system and the client's data retention policies.

Timing of Developing the Audit Strategy. In some cases, the auditor may have sufficient information to establish a preliminary audit strategy prior to performing extensive risk assessment procedures based on knowledge from past experience with the client and the results of preliminary engagement activities. For example, in a continuing engagement, the auditor may be able to establish a preliminary audit strategy after completing the client continuance procedures based on knowledge from the previous engagements and discussions with the client regarding any new issues or changes in client circumstances.

For new engagements, the auditor may have gained sufficient information while performing client acceptance procedures and gathering information for the fee proposal that would allow the development of a preliminary audit strategy. In fact, many auditors collect enough information during this process to make preliminary decisions on the assessment of overall risks, the determination of personnel requirements, use of specialists or other auditors, and other overall strategy matters. In these situations, the auditor simply needs to gather additional information throughout the performance of the risk assessment procedures to complete the overall audit strategy.

Communicating with Those Charged with Governance. The auditor may discuss elements of the overall audit strategy with those charged with governance. Both SAS No. 114 and the Yellow Book require the auditor to communicate with those charged with governance about certain planning aspects of the audit. When these discussions occur, the auditor should be careful not to compromise the effectiveness of the audit, for example, by discussing the detailed nature and timing of audit procedures.

Documentation. Establishing the overall audit strategy need not be complex or time consuming. Professional standards do not require that a separate audit strategy memorandum be prepared to document all matters that affect audit strategy. Many of the matters that relate to the overall audit strategy would be documented in the normal course of gathering information about the entity and its environment, and there is no need for a separate memorandum.

Documentation of Communications with Other Entities. The auditor might communicate with grantor agencies (including pass-through entities) or federal or state auditors or other oversight entities to aid in planning the audit. The GAS/A-133 AICPA Audit Guide, paragraph 2.48, explains that as part of establishing the overall audit strategy, the auditor should document such communications and any decisions reached as a result.

Audit Summary Memo. Although professional standards do not require separate documentation of the audit strategy itself, they do require documentation of any significant revisions to the overall audit strategy to respond to changes in circumstances. However, SAS No. 108 (AU 311.18) observes that a brief memorandum prepared at the conclusion of the previous audit, based on a review of audit documentation and highlighting issues identified in the audit just completed, can be updated and changed in the current period to provide a basis for planning the current audit. The update can be based on discussions with management of the entity. As a practical matter, some auditors frequently prepare an “audit summary memo” as part of their engagement completion procedures to provide a convenient method of establishing a basis for planning the following year’s audit engagement.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. What factors should an auditor consider when determining if a compliance finding is material?
 - a. Regulatory.
 - b. Qualitative and quantitative.
 - c. External and internal.
 - d. Nature and complexity of transactions.
16. When calculating tolerable noncompliance during the planning phase of a single audit, the auditor must make an estimate of which of the following amounts?
 - a. Known noncompliance.
 - b. Likely noncompliance.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. What factors should an auditor consider when determining if a compliance finding is material? **(Page 164)**
- a. Regulatory. [This answer is incorrect. Regulatory factors help an auditor to understand an entity's environment.]
 - b. Qualitative and quantitative. [This answer is correct. When making the determination of whether a compliance finding is material, an auditor should consider any qualitative or quantitative factors.]**
 - c. External and internal. [This answer is incorrect. External and internal factors are factors that might create incentives/pressures, provide opportunities, or enable rationalization of fraud.]
 - d. Nature and complexity of transactions. [This answer is incorrect. The nature and complexity of transactions is an example of factors that affect the likelihood of material misstatements caused by errors in properly recording the transaction that the engagement.]
16. When calculating tolerable noncompliance during the planning phase of a single audit, the auditor must make an estimate of which of the following amounts? **(Page 165)**
- a. Known noncompliance. [This answer is correct. The term known noncompliance means noncompliance that the auditor detects when applying auditing procedures. During planning, it is necessary for the auditor to make an estimate of the amount of known noncompliance. This amount has to be considered during planning because, if it is significant, it reduces the auditor's allowance for undetected noncompliance.]**
 - b. Likely noncompliance. [This answer is incorrect. Likely noncompliance is a type of noncompliance the auditor must address when evaluating materiality in relation to a major program.]

CONSIDERATION OF FRAUD

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, establishes standards and provides guidance on the auditor's responsibility to consider the risks of material misstatement of the financial statements due to fraud and to design the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated.

Applicability of SAS No. 99 in an Audit of Federal Award Programs

SAS No. 99 AU 316 establishes standards and provides guidance on the auditor's responsibility to consider fraud risks and to design the audit to provide reasonable assurance of detecting fraud that results in the *financial statements* being materially misstated. The AICPA Practice Aid, *Fraud Detection in a GAAS Audit—Revised Edition*, notes that because SAS No. 99 only applies to an audit of financial statements, the requirements of the SAS do not apply to the audit of an entity's compliance with specified requirements applicable to its major federal award programs. Paragraph 6.25 of the GAS/A-133 AICPA Audit Guide provides the following guidance:

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. . . . AU section 316 . . . 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.

Although SAS No. 99 relates to fraud in the financial statements, the GAS/A-133 AICPA Audit Guide and the AICPA Practice Aid, *Fraud Detection in a GAAS Audit—Revised Edition*, indicate that when assessing audit risk in an audit of federal award programs, auditors should specifically assess the risk that material noncompliance with requirements applicable to a major program could occur due to fraud. The results of such assessment should be considered when designing the audit procedures to be performed. In addition, in an audit of federal award programs, there may be certain factors and conditions present that are fraud risk factors relating to noncompliance even though they may not present a risk of material misstatement to the financial statements. In many cases, there may be controls that mitigate risks of material misstatement or noncompliance due to fraud.

The previous section discusses the consideration of audit risk at the financial statement level and the account balance or transaction class levels. In both a single audit and a program-specific audit, the auditor's consideration of fraud is not separate from consideration of audit risk at those levels, but is integrated into the overall risk assessment process. This lesson provide more specific guidance on assessing the risk of material misstatement and noncompliance due to fraud when assessing risk.

Because of the difference between a program-specific audit and a single audit, it is believed there are also applicability in program-specific audits differences in the auditor's responsibility for fraud risk assessment. In a single audit, the auditor should perform the fraud risk assessment process required by SAS No. 99 as part of performing the audit of financial statements. In the federal award part of the single audit, auditors should specifically assess the risk that material noncompliance with requirements applicable to a major program could occur due to fraud and consider that assessment when designing the audit procedures. However, while SAS No. 99 fraud risk factors relating to federal awards should be considered, the formal fraud risk assessment process and documentation requirements are not applicable to the federal award part of the audit. In many instances, however, the auditors believe that including the assessment of fraud risks relating to federal programs as part of the assessment of fraud risks in the financial statements will be effective and efficient. It is believed that auditors should follow the guidance in SAS No. 99 in an audit of program financial statements (financial statement portion of a program-specific audit)

since it involves providing an opinion of such statement(s), even if the program financial statement is simply the schedule of expenditures of federal awards.

Types of Misstatements Caused by Fraud

SAS No. 99, (AU 316.05) defines fraud as “an intentional act that results in a material misstatement in financial statements that are the subject of an audit.” The SAS outlines the following three conditions that generally are present when fraud occurs:

- *Incentive/Pressure.* Management or other employees have a reason to commit fraud.
- *Opportunity.* Circumstances, such as ineffective controls, the absence of controls, or the ability to override controls enable management or other employees to commit fraud.
- *Attitude/Rationalization.* Management or other employees are able to justify the acceptability of committing fraud.

SAS No. 99 addresses the following two types of misstatements that are relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements resulting from fraudulent financial reporting.
- Misstatements resulting from misappropriation of assets.

When obtaining an understanding of the environment in which the entity operates, SAS No. 99 requires auditors to consider whether *fraud risk factors* are present. *Fraud risk factors* are events or conditions that indicate the presence of incentives or pressures to commit fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify the fraud. The example fraud risk factors presented in SAS No. 99 and in the AICPA's *Fraud Detection in a GAAS Audit—Revised Edition* are broken down into factors related to fraudulent financial reporting and factors related to misappropriation of assets. Because it may be helpful to consider fraud risk factors in the context of the conditions generally present when fraud occurs, the SAS and implementation guidance further break the illustrative risk factors down into conditions relating to incentives/pressures, opportunities, and attitudes/rationalizations. It is important to note that these are only examples and the auditor also may consider other risk factors not specifically listed in the standard.

Misstatements Resulting from Fraudulent Financial Reporting. Misstatements resulting from fraudulent financial reporting (often referred to as management fraud) are intentional misstatements or omissions of amounts or disclosures from the financial statements with the intent of deceiving financial statement users. The effect of those misstatements causes the financial statements not to be presented, in all material respects, in conformity with GAAP (or an OCBOA). The AICPA Practice Aid, *Fraud Detection in a GAAS Audit—Revised Edition*, indicates there may be certain factors and conditions present that are fraud risk factors relating to noncompliance even though they may not present a risk of material misstatement to the financial statements. Examples that may be encountered in an entity with federal award programs include the following:

Incentive/Pressure

- Unusual or highly complex program transactions (particularly those near year-end) that are difficult to assess for substance over form.
- Unrealistically aggressive budget or program goals.
- Unusually significant pressures on meeting performance targets (for example, obtaining federal and state awards and meeting program performance goals).
- Significant pressure to obtain additional grants or contributions to fund the entity's activities.

Opportunity

- Indicators that one or more individuals not in an executive position with the entity have substantial influence over operations of the programs such as fundraisers or politicians.
- Domination of program management by a single individual or small group without compensating controls such as effective oversight by the governing body, inspector general, or other group.
- The governing body or program management lacks appropriate knowledge or experience regarding the operation of award programs.
- Recent occurrence of a significant or unexpected change in program management or members of the governing body or a potential for such changes in the near term.

Attitude/rationalization

- No apparent communication within program operations of acceptable operating practices, conflict of interest policies, and codes of conduct.
- Program management has a history of alleged fraud or violations of laws and regulations.
- Program management inadequately monitors significant internal controls over program operations.
- Failure to establish controls to provide reasonable compliance with laws and regulations and the provisions of contracts and grant agreements.

Misstatements Resulting from Misappropriation of Assets. Misstatements resulting from misappropriation of assets (often referred to as defalcation, embezzlement, theft, or employee fraud) involve theft of the entity's assets that results in the financial statements not being presented, in all material respects, in conformity with GAAP (or an OCBOA). Misappropriation of assets can be committed in many ways, including embezzlement of cash receipts, stealing assets, or causing the entity to pay for goods and services not received (or paying inflated prices for goods and services received). This type of fraud may be facilitated by the falsification, alteration, or other manipulation of accounting records or source documents, possibly by circumventing controls. Examples that may be encountered in an entity with federal award programs include:

Incentive/pressure

- Known or anticipated future program employee layoffs.
- Unfavorable recent or anticipated changes in program employee compensation or benefit plans.
- Failure to receive promotions or other expected rewards.

Opportunity

- The entity maintains or processes large amounts of program cash.
- The program inventory is easily susceptible to misappropriation (such as small size, high value, or high demand).
- The program is susceptible to fraudulent, unauthorized disbursements (such as vendor or payroll disbursements) being made in amounts that are material to the program financial statements.
- Lack of an appropriate system for authorizing and approving program transactions (for example, in purchasing or payroll disbursements).

Attitude/rationalization

- Program employees or volunteers with access to assets susceptible to misappropriation disregard the need to adequately monitor and safeguard assets.

- Program employees or volunteers with access to assets susceptible to misappropriation disregard internal controls designed to prevent or detect misappropriation, for example, by overriding controls or failing to correct known deficiencies in controls.
- Known or observable personal financial pressures affecting program employees with access to assets susceptible to misappropriation.
- Evidence of program employees with access to assets susceptible to misappropriation who are “living beyond their means.”

The Auditor's Responsibility for Fraud Detection

SAS No. 107 (AU 312.03) states, “The auditor’s responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements whether caused by errors or fraud, are detected.” In other words, the auditor is responsible for planning the audit to detect material misstatements due to fraud. SAS No. 99 does not increase the auditor’s responsibility for the detection of material misstatement due to fraud. However, SAS No. 99 does require the auditor to specifically identify and assess risks that may result in material misstatement of the financial statements due to fraud and to respond to the results of the assessment when gathering and evaluating audit evidence.

An auditor cannot obtain absolute assurance that the financial statements are free of material misstatements caused by fraud. Because of the nature of audit evidence and the characteristics of fraud, even a properly planned and performed audit may not detect a material misstatement resulting from fraud. Fraudulent activity often involves collusion, misrepresentation, or falsified documents. In addition, fraudulent financial reporting frequently involves management override of controls that in some cases might appear to be operating effectively. As a result, auditors may rely unknowingly on audit evidence that appears to be valid but is, in fact, fraudulent. In addition, audit procedures that are effective for detecting errors may not be effective for detecting fraud.

Immaterial Misstatements Caused by Fraud. AU 110.02 states—

The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.

However, many frauds may not result in the financial statements being materially misstated for any individual period, but may be perceived to be material, especially if the amounts involved accumulate over time.

The auditor is not responsible under professional standards for detecting immaterial fraud. However, many small governments and nonprofit organizations have the expectation that the auditor should detect all cases of fraud, whether the financial statements are materially misstated or not. This perception of the auditor’s responsibility goes beyond what is required by professional standards. To eliminate this expectation gap, it is important for auditors to inform their clients about the auditor’s responsibility under professional standards.

The Importance of Professional Skepticism

GAAS requires the auditor to exercise due professional care in planning and performing the audit. SAS No. 1 at AU 230.07 states that “due professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.” [Emphasis added.] Because the characteristics of fraud include concealment, misrepresentation, falsified documents, and collusion, the need for professional skepticism is especially important when considering the risks of material misstatement due to fraud. When exercising professional skepticism, auditors suspend any belief in management’s honesty and integrity and approach the audit with a questioning mind. Regardless of past experience with the client, auditors acknowledge and remain open and alert to the possibility that material misstatement due to fraud may exist. All of the information and evidence gathered by the auditor is critically evaluated and an ongoing assessment is made of whether the evidence suggests that the financial statements are materially misstated due to fraud. The auditor should not be willing to accept less than persuasive evidence based on a belief that management is honest.

The Auditor's Fraud Risk Assessment Process

SAS No. 99 requires auditors to assess identified risks of material misstatement due to fraud. Although the SAS uses the term assess, this is not intended to require a separate, specific conclusion about risk such as a high, moderate, or low level. Instead, the assessment involves determining whether identified risks due to fraud are mitigated by antifraud programs and controls, and the effect of those considerations on the auditor's response.

SAS No. 99 states that the auditor should ordinarily presume there is a risk of material misstatement due to fraud relating to revenue recognition. Because grants to governmental and not-for-profit entities often have significant restrictions, the auditor might inquire of management or in-house legal counsel about grants including their knowledge of any unusual grant terms or conditions. The auditor would also consider whether management is under any pressure that might lead to overriding of controls, such as pressure to meet matching requirements.

Grants typically have significant restrictions. If the auditor becomes aware that the client must comply with those restrictions or potentially repay the grant, the auditor might consider:

- How management has responded to the risk.
- What controls management has instituted to reduce the risks of misstatement and noncompliance. (For example, management may have assigned someone to monitor compliance with grant restrictions and prepare periodic reports detailing how the organization is meeting the restrictions.)

The auditor would then consider (a) whether specific controls could effectively mitigate the risks and (b) the evidence available to assess whether the specific controls are operating effectively. Based on this risk assessment process, the auditor would then design substantive procedures in response to the remaining specific risk of misstatement or noncompliance.

SAS No. 99 outlines the following fraud risk assessment process:

- a. Hold a discussion among engagement team members to consider the susceptibility of the client's financial statements to material misstatement due to fraud and to reinforce the importance of professional skepticism.
- b. Obtain other information needed to identify risks of material misstatement due to fraud.
- c. Identify risks that may result in material misstatement due to fraud.
- d. Assess the identified risks after taking into account an evaluation of the entity's antifraud programs and internal controls.
- e. Respond to the results of the risk assessment.

Auditors gather other information that may be relevant to identifying fraud risks while obtaining an understanding of the entity and its environment, its internal control, and its fraud risk factors, and from the performance of preliminary analytical procedures. Other information auditors should consider in identifying fraud risks includes the discussion among engagement team members, information from client acceptance and continuance procedures, the auditor's inherent risk assessment and, if applicable, reviews of interim financial reports.

If the auditor identifies risks of material misstatement or material noncompliance due to fraud, the audit response may be overall or specific, and may include substantive procedures or tests of controls. (However, substantive analytical procedures alone are not a sufficient response.) Overall responses have an overall effect on how the audit is conducted.

Documenting the Fraud Risk Assessment. SAS No. 99 (AU 316.83) requires the auditor to document evidence that he or she assessed the risks of material misstatement due to fraud. The auditor is required to document the following:

- The discussion among engagement team members in planning the audit.

- The procedures performed to gather information needed to identify and assess fraud risks.
- Fraud risks identified.
- The response to those risks.
- If applicable, how the auditor overcame the presumption that improper revenue recognition is a fraud risk.
- The results of procedures to address the risk of management override of controls.
- Additional conditions, if any, requiring a response and the response(s) to those conditions.
- The nature of communications about fraud.

Applicability of SAS No. 99 to a Single Audit. SAS No. 99 establishes standards for financial statement fraud. Paragraph 8.11 of the AICPA Audit Guide *Government Auditing Standards and Circular A-133 Audits* notes that SAS No. 99 only applies to an audit of financial statements and not to a compliance audit. However, the audit guide also states that the auditor should assess the risk of material noncompliance with a major program's compliance requirements due to fraud in a single audit. Therefore, it is recommended that the auditor assess the risk of major program material noncompliance as part of the financial statement fraud risk assessment process required by SAS No. 99. The results of such assessment may impact which audit procedures are performed. However, while SAS No. 99 fraud risk factors relating to major programs should be considered, the formal fraud risk assessment process and documentation requirements are not applicable to the federal award part of the audit. In many instances, however, it is believed that including the assessment of fraud risks relating to major programs as part of the assessment of fraud risks in the financial statements will be effective and efficient.

Program-specific Audit. While the AICPA's *Fraud Detection in a GAAS Audit—Revised Edition* and the GAS/A-133 AICPA Audit Guide do not specifically address the applicability of SAS No. 99 to program-specific audits, the authors believe that auditors should follow the guidance in SAS No. 99 in an audit of program financial statements since it involves providing an opinion of such statement(s), even if the program financial statement is simply the schedule of expenditures of federal awards.

Communication Requirements

Generally Accepted Auditing Standards. Although SAS No. 99 applies only to an audit of financial statements, the auditor may want to consider its guidance when planning and performing an audit of an entity's compliance with specified requirements applicable to its major programs. If the auditor determines that there is evidence that fraud may exist (even if the matter is inconsequential), SAS No. 99, (AU 316.79) requires the auditor to report it to the appropriate level of management. If the fraud or potential fraud involves senior management or causes the financial statements to be materially misstated, it should be reported directly to those charged with governance. Auditors should reach an understanding with those charged with governance about the nature and extent of communication about misappropriations committed by lower level employees. In the absence of such an agreement, it is believed the auditor should report all instances of fraud to both the appropriate level of management and to those charged with governance. It is recommended that communications about possible fraud be made in writing; if made orally, the nature of the communication should be documented in the workpapers.

SAS No. 99 (AU 316.82) acknowledges that in some cases, the auditor may have a duty to disclose fraud to outside parties. Examples of those situations include the following:

- To comply with legal or regulatory requirements.
- To a successor auditor making inquiries in accordance with SAS No. 84, *Communications Between Predecessor and Successor Auditors*.
- When responding to a subpoena.
- To a government funding agency or other specified agency, such as a cognizant or oversight agency, when complying with requirements for audits of recipients of governmental financial assistance.

Before disclosing instances of fraud to outside parties, it is recommended the auditor consult with legal counsel due to the nature of the auditor's ethical and legal obligations.

In addition, if any of the identified fraud risks have internal control implications, the auditor should determine whether they represent deficiencies related to the entity's internal control that should be reported to management and others in accordance with SAS No. 112 or SAS No. 115 or matters that should be reported in the Yellow Book report on compliance and on internal control over financial reporting or the OMB Circular A-133 report on compliance with requirements applicable to each major program and on internal control over compliance. The absence of or deficiencies in programs and controls designed to mitigate or otherwise prevent, deter, and detect fraud may also be matters that require communication.

Government Auditing Standards. In audits performed under *Government Auditing Standards*, auditors are required to report all instances of fraud and illegal acts, unless inconsequential, and violations of provisions of contracts or grant agreements and abuse that could have a material effect on the financial statements.

Government Auditing Standards—2007 Revision, at Paragraph 5.18, provides two circumstances in which auditors are required to report known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse directly to outside parties. These two requirements are in addition to any legal requirements for direct reporting. If an entity is required by legal or regulatory requirements to report certain fraud, illegal acts, violations of contracts or grant agreements, or abuse to specified external parties but does not make the required report as soon as practicable after the auditor's communication to those charged with governance, then the auditor should report it to the required external parties. Also, auditors may be required to report directly when fraud, illegal acts, violations of contract or grant agreements, or abuse involve awards received from a government agency and management fails to make timely and appropriate remedial steps. If management has asserted that it has reported fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse as required by laws, regulations, and contracts or grant agreements, the auditor should obtain sufficient appropriate audit evidence (for example, by confirmation with outside parties) to corroborate management's assertion.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. Which of the following is an example of incentive and/or pressure in regards to misstatements resulting from fraudulent financial reporting?
- a. History of alleged fraud by program management.
 - b. Unrealistic program goals.
 - c. Employees with nonexecutive positions having substantial influence over operations of programs.
 - d. Poorly monitored controls over program operations.
18. Which of the following does SAS No. 1 indicate?
- a. That due professional care requires the auditor to exhibit professional skepticism.
 - b. The final assembly and completion of the audit file should occur within 60 days of the report release date.
 - c. That risk assessment procedures by themselves do not provide enough appropriate audit evidence on which to base the audit opinion.
 - d. That "once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources."

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. Which of the following is an example of incentive and/or pressure in regards to misstatements resulting from fraudulent financial reporting? **(Page 176)**
- a. History of alleged fraud by program management. [This answer is incorrect. This is an example of attitude/rationalization.]
 - b. Unrealistic program goals. [This answer is correct. Unrealistic program goals and aggressive budgets can often create incentive and pressure on employees to commit fraud. Another incentive/pressure includes substantial pressure to obtain additional grants or contributions to fund the entity's activities.]**
 - c. Employees with nonexecutive positions having substantial influence over operations of programs. [This answer is incorrect. This is an example of an employee placed in a position to have an opportunity to commit fraud.]
 - d. Poorly monitored controls over program operations. [This answer is incorrect. An employee could rationalize their desire to commit fraud when program management inadequately monitors significant internal controls over program operations.]
18. Which of the following does SAS No. 1 indicate? **(Page 178)**
- a. That due professional care requires the auditor to exhibit professional skepticism. [This answer is correct. According to SAS No. 1, "due professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence."]**
 - b. The final assembly and completion of the audit file should occur within 60 days of the report release date. [This answer is incorrect. This statement was issued by SAS No. 103.]
 - c. That risk assessment procedures by themselves do not provide enough appropriate audit evidence on which to base the audit opinion. [This answer is incorrect. This statement was issued by SAS No. 106.]
 - d. That "once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources." [This answer is incorrect. This statement comes from SAS No. 108.]

OVERALL ASPECTS OF AUDIT PROGRAMS AND AUDIT DOCUMENTATION REQUIREMENTS

Overall Aspects of Audit Programs

In planning an audit, SAS No. 108, (AU 311.19–.20), states the following:

The auditor must develop an audit plan in which the auditor documents the audit procedures to be used that, when performed, are expected to reduce audit risk to an acceptably low level. The audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

As part of developing the overall audit strategy, the auditor will ordinarily have identified programs, locations, account balances, and audit areas where there may be higher risks of material misstatement/noncompliance. SAS No. 108, (AU 311.17), notes that “once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor’s resources.” The audit plan is commonly referred to as the audit program.

Assertions. In forming an opinion on the financial statements and performing procedures related to compliance of federal award programs, an auditor obtains and evaluates evidence about the assertions made by management. Assertions are what management is saying, either explicitly or implicitly, about the recognition, measurement, presentation, and disclosure of information in the financial statements (or schedule of expenditures of federal awards) and related disclosures. When designing an audit program, the auditor needs to obtain evidence to support relevant assertions. Therefore, in a single audit, the auditor should design and perform substantive procedures for all assertions relevant to the compliance requirements for each major program.

The risk assessment standards give prominent recognition to the idea of relevant assertions. Relevant assertions are identified by evaluating the following:

- The source of likely potential misstatement or noncompliance.
- The nature of the assertion.
- The volume of transactions or data related to the assertion.
- The nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertions.

Audit Objectives. An audit objective is, in effect, an assertion translated into terms relevant to a specific account or federal award program. When the assertions are restated in specific terms for an account or program, they become audit objectives for an auditor to achieve in designing an audit program. The Compliance Supplement contains audit objectives for each type of compliance requirement that the auditor should consider in planning and performing tests of compliance requirements.

Audit Procedures. The basic requirement for selection of audit procedures, according to SAS No.106 (AU 326.20), is that the auditor should obtain audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures to—

- a. 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 (i.e., *risk assessment procedures*);
- b. When applicable, test the operating effectiveness of controls in preventing or detecting material misstatements at the relevant assertion level (i.e., *tests of controls*); and

- c. Detect material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as *substantive procedures* and include tests of details of classes of transactions, account balances, and disclosures, and substantive analytical procedures).

SAS No. 106 (AU 326.21) further states that risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion. Auditors must supplement risk assessment procedures with further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

The Compliance Supplement also contains suggested audit procedures for testing compliance. The auditor should use professional judgment in determining the audit procedures to be performed to obtain sufficient appropriate audit evidence to form an opinion on the entity's compliance with the compliance requirements that could have a direct and material effect on each major program.

Audit Program Format

Audit programs need to incorporate consideration of specific audit objectives and appropriate audit procedures to achieve the specified objectives.

Basic audit procedures are cross-referenced to specific audit objectives. The letters preceding each of the audit objectives (e.g., A, B, etc.) serve as identification codes. These codes are presented in a left-hand column labeled "Audit Objectives" when a procedure accomplishes an objective. If the alpha code appears in brackets (e.g., [A], [B], etc.), the audit procedure only secondarily accomplishes the objective. If an asterisk precedes a procedure, it is a preliminary step or follow-up step that does not accomplish an objective.

Documentation Requirements

SAS No. 110 (AU 318.77) requires the auditor to document the following related to preparing the detailed audit plan:

- The overall responses to address the assessed risks of material misstatement at the financial statement level.
- 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.

SAS No. 108, (AU 311.21), states that the audit plan should include the following:

- A description of the nature, timing, and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement.
- A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level for each material class of transactions, account balance, and disclosure.
- A description of other audit procedures to be carried out for the engagement in order to comply with generally accepted auditing standards (for example, seeking direct communication with the entity's lawyers).

SAS No. 108, (AU 311.21), notes that planning for audit procedures takes place during the course of the audit and that the risk assessment procedures may cause a change in planned specific further audit procedures. That paragraph also states that the auditor should document changes to the original audit plan.

Both AICPA standards and *Government Auditing Standards* establish audit documentation requirements that should be considered when planning an audit. Those standards state that auditors should prepare audit documentation that enables an experienced auditor with no previous connection to the audit to understand the following:

- The nature, timing, extent, and results of the audit procedures performed to comply with SASs, *Government Auditing Standards*, and other applicable standards and requirements,
- The results of the audit procedures performed and the audit evidence obtained,
- The conclusions reached on significant matters, and
- That the audited financial statements or other audited information agree or reconcile with the underlying accounting records.

SAS No. 103 also provides certain specific audit documentation requirements as follows:

- a. *Abstracts or Copies of the Client's Records.* The workpapers should include copies of the client's records and abstracts or copies of significant contracts or agreements examined, if they are needed to allow an experienced auditor to understand the work performed and conclusions reached.
- b. *Identification of Items Tested.* Documentation of procedures performed, including tests of controls and substantive tests of details involving inspection of documents or confirmation, should identify the items tested.
- c. *Individuals Performing and Reviewing the Work, and Associated Dates.* When documenting the audit procedures performed, auditors should record who performed the work, the date of completion, who reviewed specific documentation, and the date of the review.
- d. *Significant Findings or Issues.* Auditors are required to document information related to significant audit findings or issues.
- e. *Departures from the Requirements in the SASs.* In the rare instances in which an auditor deems it necessary to depart from a presumptively mandatory requirement of the SASs, documentation must be made of the justification for the departure and how alternative procedures performed were sufficient to achieve the objectives of the requirement.
- f. *Revisions after the Date of the Auditor's Report.* Auditors are required to document certain items if revisions to the workpapers are necessary after the date of the auditor's report. Revisions may be attributable to:
 - Omitted procedures that would have been considered necessary at the time of the audit.
 - Subsequent discovery of facts that existed at the date of the report.
 - Other reasons an auditor considers it necessary to make an addition or change to the workpapers after the documentation completion date.
- g. *Report Release Date.* The report release date should be recorded in the audit documentation.

The Yellow Book, at Paragraph 4.20, requires auditors to document evidence of supervisory review before the report is issued of work performed that supports findings, conclusions, and recommendations contained in the audit report.

SAS No. 103 expands the auditor's documentation requirements and provides guidance on revisions to audit documentation made after the date of the auditor's report. It requires audit documentation to be assembled into a final engagement file within 60 days following delivery of the auditor's report to the client. After that date, audit documentation should not be deleted or discarded. Additions to documentation after that date should indicate when and by whom the change was made, the reason for the change, and the effect on the auditor's conclusions.

SAS No. 103 imposes a five-year document retention period for audit documentation. The SAS also requires audit documentation to be sufficient to enable an experienced auditor with no previous connection to the audit to understand the nature, timing, extent, and results of the procedures, the evidence obtained, and the auditor's significant conclusions. An *experienced auditor* is defined as an individual with sufficient skills to have performed the audit, including an understanding of audit processes and reporting issues relevant to the client's industry.

Government Auditing Standards Requirements for Access to Audit Documentation. When a nonprofit or governmental organization expends federal awards, audit staffs of grantor agencies are permitted access to the auditor's workpapers, and additional documentation may be necessary to meet GAO standards. Paragraph 4.23 of the Yellow Book states that "subject to applicable laws and regulations, auditors should make appropriate individuals, as well as audit documentation, available upon request and in a timely manner to other auditors or reviewers."

Other Audit Documentation Considerations

Retention. Auditors should establish policies and procedures regarding the retention of workpapers. These policies should be for a time frame that meets the needs of the auditor's practice and considers any regulatory or legal requirements regarding document retention. SAS No. 103 specifically indicates that this period should not be shorter than five years from the report release date. This is a longer retention period than established by OMB Circular A-133 for a single audit.

Ensuring the Integrity of Workpapers. Auditors are required to apply appropriate, reasonable controls to protect the integrity, retrievability, and accessibility of workpapers. Controls are necessary to prevent workpapers from unauthorized use or alteration or from becoming lost or damaged. According to SAS No. 103, such controls should—

- Enable clear identification of when and by whom documentation was created, changed, or reviewed.
- Ensure the integrity of the information at all stages of the audit. This is critical when the information is shared among the audit team or electronically transmitted to other parties.
- Permit necessary access to the documentation by the audit team or other authorized parties.
- Prevent unauthorized changes to documentation.

The 2007 Yellow Book, at Paragraph 4.22, requires audit firms to establish policies and procedures for the safe custody and retention of audit documentation. It further states that when audit documentation is stored electronically, the audit firm is required to establish information systems controls over accessing and updating the audit documentation.

It is recommended that firms develop consistent policies and underlying controls for all audit engagements that address integrity, retrievability, and accessibility. However, such controls may vary based on the stage of the audit (e.g., field work still in progress, after field work but before the documentation completion date, and after the documentation completion date) and the nature of the workpaper media (e.g., paper or electronic).

Loss or Destruction of Audit Documentation. The AICPA has issued a Technical Practice Aid (TIS 8345.02) that addresses the destruction of audit documentation by fire, flood, or natural disaster. It is believed the guidance also would apply if workpapers are lost, deleted, or damaged due to other circumstances. The TPA indicates that if audit documentation is destroyed prior to the issuance of the auditor's report, the auditor must either recreate the audit documentation for the procedures performed or re-perform the audit procedures and create new documentation. The auditor cannot issue a report indicating that he or she has performed an audit under professional standards without the required documentation, nor can he or she use oral explanations as the principal support for the work that was performed.

When determining whether to recreate the documentation or reperform the procedures, the auditor should consider whether he or she will be able to demonstrate that sufficient competent evidential matter has been obtained to afford a reasonable basis for expressing an opinion on the financial statements. Except for very small engagements, it is believed it is unlikely that the auditor will be able to recreate sufficient documentation without reperforming at least some of the procedures.

The GAO has also provided guidance for situations in which the auditor's documentation for a Yellow Book audit is lost or destroyed. The GAO states that if the auditor's work product is lost or destroyed after the audit was completed (or partially completed) but before the auditor's report is issued, the auditor will not meet the Yellow Book requirement that audit documentation "contain support for findings, conclusions, and recommendations before auditors issue their report." The GAO states that the audit firm and the auditee will need to weigh the costs and benefits of recreating audit documentation or reperforming audit procedures with the need for public accountability. External oversight bodies should be consulted to determine whether there is a legal or regulatory requirement for the audit and, if so, how to meet the requirements.

Documenting Revisions after the Date of the Auditor's Report. Timely completion of audit documentation is critical to assure audit quality. As a practical matter, the auditor should strive to prepare audit documentation as the audit progresses to avoid inadvertently omitting critical information or incorrectly recording aspects of the procedures that were completed or the evidence obtained. GAAS include requirements for (a) assembling and completing the workpapers at the conclusion of the audit and (b) making revisions to the documentation after the date of the auditor's report. These requirements are centered on the following key dates:

- The audit report date.
- The report release date.
- The documentation completion date.

Audit Report Date. The date of the auditor's report should be no earlier than the date sufficient appropriate audit evidence has been obtained to support the opinion on the financial statements. The same requirement applies to dating the auditor's report on the schedule of expenditures of federal awards, if applicable, and the report on compliance with requirements applicable to major federal programs. Among other items, sufficient appropriate audit evidence includes evidence that—

- the audit work has been reviewed;
- the financial statements, including disclosures, have been prepared; and
- management has taken responsibility for the financial statements and the schedule of expenditures of federal awards.

Report Release Date. The report release date is the date that the auditor gives the client permission to use the auditor's reports. For most audits, this will be the date that the auditor delivers the report to the client. SAS No. 103 requires the auditor to document the report release date in the workpapers. In most cases, the report release date should be close to the date of the auditor's reports. Many firms adopt a policy about when to date their auditor's report if there is a delay in releasing the report (that is, how long of a delay makes it necessary to redate the report). A decision to redate the report should result in extending the subsequent events review to the later date. Auditors should consider covering that matter in their firm's quality control policies and procedures. If there are significant delays in releasing the reports, auditors should consider the need to apply subsequent events procedures.

Documentation Completion Date. SQCS No. 7 (QC 10.62) specifies that firms "should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis, as appropriate for the nature of the engagement, after the engagement reports have been released." Those policies and procedures should comply with any time limits established by professional standards, laws, or regulations that address the assembly of final engagement files for specific types of engagements. The final assembly and completion of the audit file should occur within 60 days of the report release date. The report release date discussed in SAS No. 103 refers to the date that workpapers should be completed as the documentation completion date. After that date, the auditor must not delete or discard any documentation prior to the required five-year retention period. Auditors may adopt documentation completion periods that are shorter than 60 days, either on an engagement-by-engagement basis, or as part of the firm's policy of quality control. In addition, the auditor should consider whether there are regulatory or state requirements that require a shorter documentation completion period.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Which of the following statements regarding assertions is most accurate?
- a. An assertion is what management is implicitly stating regarding the disclosure of information in the financial statements.
 - b. Assertions are what the auditor uses when planning the first step in designing the audit program.
20. Which of the following statements regarding the retention and integrity of work papers is **least** accurate?
- a. According to SAS No. 103, the period in which work papers are retained should be less than 10 years from the report release date.
 - b. Work papers must be protected from unauthorized use by means of controls.
 - c. Audit firms are required to create procedures and policies for the safe custody of audit documentation.
 - d. If any portion of the audit documentation is destroyed prior to the issuance of the auditor's report, the auditor must recreate the audit documentation for the procedures performed.
21. How many days after the report release date should the auditor complete the final assembly of the audit file?
- a. 30.
 - b. 60.
 - c. 90.
 - d. 180.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Which of the following statements regarding assertions is most accurate? **(Page 185)**

- a. **An assertion is what management is implicitly stating regarding the disclosure of information in the financial statements. [This answer is correct. Management's comments regarding the measurement, presentation, recognition and disclosure of information in the financial statements and related disclosures are considered assertions either explicitly or implicitly.]**
- b. Assertions are what the auditor uses when planning the first step in designing the audit program. [This answer is incorrect. Management can use assertions as a mental checklist when developing specific audit objectives.]

20. Which of the following statements regarding the retention and integrity of work papers is **least** accurate? **(Page 188)**

- a. **According to SAS No. 103, the period in which work papers are retained should be less than 10 years from the report release date. [This answer is correct. The period is no shorter than five years. The retention period established by OMB Circular A-133 is shorter.]**
- b. Work papers must be protected from unauthorized use by means of controls. [This answer is incorrect. It is the auditor's responsibility to protect all work papers from unauthorized use or alteration through means of controls. Enabling clear identification of when and by whom documentation was created is an example of a control.]
- c. Audit firms are required to create procedures and policies for the safe custody of audit documentation. [This answer is incorrect. According to the 2007 Yellow Book, Paragraph 4.22, firms are responsible for maintaining the retention and safety of audit documentation.]
- d. If any portion of the audit documentation is destroyed prior to the issuance of the auditor's report, the auditor must recreate the audit documentation for the procedures performed. [This answer is incorrect. This is a requirement of the AICPA Technical Practice Aid.]

21. How many days after the report release date should the auditor complete the final assembly of the audit file? **(Page 189)**

- a. 30. [This answer is incorrect. The oversight agency has 30 days to notify the auditee of any reassignment.]
- b. **60. [This answer is correct. An auditor must complete the final assembly of the audit within 60 days of the report release date.]**
- c. 90. [This answer is incorrect. The auditor does not have three months or 90 days to complete the final assembly of the audit file.]
- d. 180. [This answer is incorrect. The federal agency is responsible for notifying entities receiving awards under such programs at least 180 days before the end of the fiscal year being audited.]

PART OF AUDIT PERFORMED BY OTHER AUDITORS

Reasons for Use of Other Auditors

A single audit, in some instances, involves the use of more than one auditor. The reasons, the auditor's responsibilities when part of an audit is performed by other auditors, as well as new communication requirements when the auditor uses third-party service providers, are discussed in the following paragraphs.

Use of Small, Minority-owned, or Woman-owned Firms. Section 305(a) of OMB Circular A-133 requires entities that expend specified amount of federal awards to "make positive efforts to utilize small businesses, minority-owned firms, and women's business enterprises" for participation in contracts awarded to fulfill single audit requirements. This requirement is often met by involving a small, minority-owned, or woman-owned firm in a portion of the single audit engagement.

Use of Other Auditors. Another situation that involves the use of other auditors is the separation of the engagement between the principal auditor of the primary governmental or nonprofit organization and the secondary auditor of a separate department, agency, or other organizational unit (unit) of the reporting entity. This situation is fairly common in governmental engagements.

Use of Third-party Service Providers. Audit firms frequently subcontract portions of their audit work to other firms or to individual auditors. In 2004, the AICPA adopted new ethics rulings that members must follow when outsourcing to third-party service providers. Under the rulings, third-party service providers include entities that are not controlled by the member or member's firm and individuals who are not employed by a member or member's firm. Independent contractors used by a CPA meet the definition of third-party service providers.

Revised Ethics Ruling No. 112 (ET 191.224–.225) under Rule 102, *Integrity and Objectivity*, requires that clients be informed (preferably in writing) that the firm will use a third-party service provider in providing professional services to the client. This communication must be made before confidential client information is shared with the service provider. Ethics Rule 301, *Confidential Client Information*, requires a contractual agreement between the audit firm and the service provider for maintenance of confidentiality of client information. This rule also requires members to be reasonably assured that the "service provider has appropriate procedures in place to prevent the unauthorized release of confidential client information."

Minimum Procedures to Be Performed

The participation of other auditors in the single audit process may be accomplished through a joint venture, a subcontractor relationship, or the result of a separate unit engaging other auditors. In these situations, the principal auditor should consider the guidance found in SAS No. 1 (AU 543), *Part of Audit Performed by Other Independent Auditors*. When using the work of another auditor, the principal auditor should—

- a. Ensure his or her own independence of the oversight entity and of each unit in the reporting entity.
- b. Confirm the other auditor's independence under AICPA requirements.
- c. Obtain the separate audited financial statements and schedule of expenditures of federal awards of each unit.
- d. Ascertain that an appropriate subsequent event review was performed for the reporting entity, including all units and federal programs. This review should include a review of correspondence the entity received after the audit date. (This relates primarily to the financial statement audit.)
- e. Obtain representation that the other audit organization and its personnel have met the requirements of *Government Auditing Standards*, including independence, competence, CPE, internal quality control, and external triennial peer review.

Deciding Whether to Make Reference to Another Auditor

When the audit of a department, agency, or other organizational unit is performed by an other auditor, the principal auditor must decide whether to make reference to the other auditor in the single audit reports. When making this decision, SAS No. 1 (AU 543.03) states—

If the principal auditor decides to assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, no reference should be made to the other auditor's work or report. On the other hand, if the principal auditor decides not to assume that responsibility, his report should make reference to the audit of the other auditor and should indicate clearly the division of responsibility between himself and the other auditor . . .

When deciding whether or not to make reference to the other auditor, the principal auditor should consider the factors outlined in SAS No. 1 (AU 543.05).

There is no provision in the professional standards that allows for a division of responsibility (reference to other auditor in the auditor's report) except as described later in this lesson. In other words, if the other auditor does not audit (and issue a report on) a separate department, agency, or other organizational unit, there should be no reference to the other auditor.

Not Making Reference to Another Auditor. When the principal auditor decides *not* to make reference or is prohibited from making reference to the other auditor in the single audit reports, he or she should consider performing one or more of the following procedures:

- a. Visiting the other auditor to discuss the procedures followed and the results of those procedures.
- b. Reviewing the other auditor's audit programs. In some situations, it may be appropriate for the principal auditor to issue instructions to the other auditor as to the scope of his or her work.
- c. Reviewing the other auditor's workpapers, including those related to internal controls, compliance with laws and regulations, and risk assessment.

Deciding to Make Reference to Another Auditor. In some cases, it may not be practical for the principal auditor to perform these procedures and he or she may decide to make reference to the other auditor in the audit reports. In other cases, the principal auditor might decide to make reference because the unit being audited by the other auditor is material to the reporting entity. When the principal auditor decides it is necessary to make reference to the other auditor, his or her report should clearly indicate the division of responsibility and the magnitude of the component audited by the other auditor.

Joint Audits

In certain joint venture situations, *each* auditor participating in the engagement will jointly sign the audit reports and thus take full responsibility for the entire audit. According to Paragraph 14.31 of SLG, a joint endeavor by two firms might take the form of a legal entity, just as individuals band together to form a firm. In that situation, the SLG states:

. . . the audit report might be signed with the joint venture name. However, before using such an approach, the auditors should consider the implications of ethics rules on the use of fictitious names and state licensing statutes. . .

According to Paragraph 2.46 of the GAS/A-133 AICPA Audit Guide, 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. In a joint audit situation, each of the auditors participating in the engagement should reach an understanding of the terms of the engagement (i.e., overall scope of the audit, standards to be adhered to, responsibilities for audit procedures and signing of reports, methods of determining compensation, supervision of the engagement, workpaper documentation and retention, review procedures, etc.). Preferably, the terms of the engagement should be documented in a contract between the auditors involved.

Use of Federal Auditors

Section 305(c) of OMB Circular A-133 allows federal auditors who comply with the requirements of the Circular to perform all or part of the Circular A-133 audit. OMB Circular A-133, Section 105, defines “auditor” as follows:

. . . 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.

Similarly, it is believed internal auditors of governmental units would not be considered “auditors,” under the Circular. The 1990 OMB Circular A-133 provided for a “coordinated audit approach.” A coordinated audit is one in which the independent auditor, federal auditor, and other auditors consider each other’s work in determining the nature, timing, and extent of audit work to be performed. Although the 1997 Circular A-133 does not use the term “coordinated audit approach,” this provision combined with the inclusion of federal and other auditors in the definition of “auditor” indicates that other auditors may perform all or part of the work required under OMB Circular A-133 if they fully comply with its requirements. When participating in an audit with federal or other auditors, the independent auditor should consult with state, local, or federal auditors, or other federal representatives, to determine whether the other auditors have performed or are performing work that may be used to satisfy some of the independent auditor’s auditing and reporting needs. In order to maximize efficiencies, this communication should be made during the planning stages of the engagement.

When participating in an audit with federal or other auditors, the auditor should follow the guidance in SAS No. 1 (AU 543), *Part of Audit Performed by Other Independent Auditors*. In addition, the auditor should consider the guidance in SAS No. 73 (AU 336), *Using the Work of a Specialist*.

In administering audits including participation by other auditors at the federal level, federal agencies may request the independent auditor to issue various reports in addition to the reports required by Circular A-133. These reports may include special reports prepared in accordance with SAS No. 62 (AU 623), *Special Reports*, as amended, or other reports on internal controls or compliance with laws and regulations. When participating in any type of audit with federal or other auditors, the auditor should be sure that he or she understands his or her auditing and reporting responsibilities and should consider documenting this understanding in the engagement letter.

Government Auditing Standards Relating to Government Auditors. The Yellow Book provides guidance relating to the organizational independence of government auditors. The Yellow Book independence standards impact a broad range of government auditors at the federal, state, and local levels. For example, they could impact certain inspector generals, service auditor generals, state and legislative auditors, and local auditors (for example, county auditors and city auditors). They may also impact independent auditors who rely on audit reports issued by such auditors. In addition, the Yellow Book independence standards also include provisions relating to internal auditors.

EXAMINATION FOR CPE CREDIT**Lesson 1 (GSATG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Bea is performing a single audit of Mayberry, Inc. (Mayberry). Which of the following reports should Bea include to comply with OMB Circular A-133?
 - i. Opinion as to whether the auditee complied with the contract provisions.
 - ii. Opinion on financial statements.
 - iii. Report on compliance with applicable major programs.
 - iv. An *in relation to opinion* on the entity's additional schedule of expenses of federal awards.
 - v. Report on compliance with laws.
 - vi. Report on internal controls over financial reporting disclosing important deficiencies in internal control.
 - a. i, ii, iii.
 - b. i, iii, iv.
 - c. ii, iii, vi.
 - d. iii, iv, v.
2. Which of the following is **not** a responsibility of the cognizant agency for audit?
 - a. Approve the recipient's choice of independent auditor.
 - b. Provide auditees and auditors with technical audit advice.
 - c. Organize reporting responsibilities of auditors to fulfill the most cost-effective audit.
 - d. Consider requests for extensions to the report submission due date from the auditee.
3. The role of a cognizant agency is similar to that of an oversight agency for audit. Which of the following is a responsibility of a cognizant agency that generally is **not** the responsibility of the oversight agency for audit?
 - a. Provide notification of fraud.
 - b. Process audit reports.
 - c. Define inadequacies.
 - d. Provide technical advice to auditees.
4. What is the determining factor when identifying an oversight agency for audit?
 - a. Total funding.
 - b. Indirect funding.
 - c. Direct funding.
 - d. Substantial funding.

5. How often should Type A programs be audited as major programs?
- Every three years.
 - Every five years.
 - Every ten years.
 - Every fifteen years.
6. Halle is planning an audit of the financial statements for Star Coffee, Inc. What is one task Halle should perform to become familiar with the state and/or local grant requirements?
- Determine if recent reviews by oversight entities have disclosed significant errors.
 - Review agreements related to the revenues and amount expended.
 - Provide technical advice to auditees.
 - Coordinate work and responsibilities among other auditors.
7. Which of the following tasks should an auditor perform when determining the state or local grant requirements?
- Determine if the state or local government has a compliance supplement for the program.
 - Read the grant agreements and any amendments, including referenced laws and regulations.
 - Identify the financial reporting entity.
 - Establish the terms of the engagement in an engagement letter.
 - Inquire of the audit divisions of the sponsoring agencies about the audit requirements applicable to the entity.
 - Determine the scope of services to be provided, including the reports to be issued.
 - Determine the amount of federal awards expended and the need for a single audit.
 - Obtain any applicable audit guidance from the grantor agency relating to the grant.
 - Consider auditee requests extensions to report submission date.
- iii; iv; vii, viii.
 - vi; vii; viii; ix.
 - iii; iv; viii; ix.
 - i; ii; v; viii.

8. When an auditor determines others within an entity to whom related questions should be directed depends on which of the following?
- a. Specific information obtained and the circumstance regarding the organization.
 - b. Due care and professional skepticism depends heavily on an effective assessment of the risk of material misstatement.
 - c. Extent of new accounting standards that is recently effective for the entity.
 - d. Degree of financial reporting sophistication of the financial management of the entity.
9. The preliminary analytical procedures used when planning an audit includes which of the following?
- a. Locating the areas that may represent specific risks significant to the audit and increasing the auditor's understanding of the client's operations that have occurred since the last audit date.
 - b. Inquiring of management all the aspects of the entity and its environment.
 - c. Considering the nature, timing, and extent of some risk assessment procedures that are relative to audit engagements.
 - d. Obtaining applicable audit guidance from the grantor agency.
10. What is required when obtaining an understanding of the entity and its environment including its internal control to assess risk?
- a. Strategy and inspection.
 - b. Experience and coordination.
 - c. Identification and consideration.
 - d. Observation and inspection.
11. What is the first thing the auditor should do when planning a single audit engagement?
- a. Understand the client's environment.
 - b. Obtain knowledge regarding the client's major federal awards programs.
 - c. Focus of the audit team's efforts.
 - d. Focused on risks already identified.
12. Who is responsible for preparing the schedule of expenditures of federal awards?
- a. Client.
 - b. Auditor.
 - c. Federal agency.
 - d. Client's legal counsel.

13. The information management can use to measure and review the federal award program performance includes which of the following?
- a. General pronouncements that is relevant to all audits of financial statements.
 - b. Inquiry of analytical procedures.
 - c. Reports prepared or received internally from regulatory agencies.
 - d. Areas susceptible to management override of controls.
14. When identifying fraud risk factors, which of the following statements is most accurate?
- a. Fraud risk is a natural indicator of the existence of fraud.
 - b. The auditor should only consider fraud risk if a fraud risks factor is present.
 - c. Fraud risk usually is not related to misappropriation of assets.
 - d. Fraud risk factors are not considered when identifying noncompliance.
15. What are the primary planning decisions relative to a single audit?
- i. Specific nature of audit procedures.
 - ii. Materiality.
 - iii. Tolerable noncompliance.
 - iv. Entity's policies.
 - v. Performance targets.
 - vi. Political environment.
 - vii. Overall audit strategy.
- a. iv; v; vi; vii.
 - b. ii; iii; v; vii.
 - c. i; iii; v; vii.
 - d. i; ii; iii; vii.
16. SAS No. 99 outlines three conditions that generally are present when fraud occurs. Which one of the following is **not** one of the conditions?
- a. Incentive/pressure.
 - b. Opportunity.
 - c. Work history.
 - d. Attitude/rationalization.

17. In regards to misstatements resulting from misappropriation of assets, which of the following examples is considered an opportunity for employee fraud?
- a. The announcement of future program employee layoffs.
 - b. Program inventory contains high-dollar inventory that is easily accessed.
 - c. Unfavorable benefit plans.
 - d. Evidence of employees "living beyond their means" with access to assets susceptible to misappropriation.
18. What is an *audit objective* in regards to an auditor developing audit objectives for a federal award program?
- a. An assertion translated into terms relevant to a specific account or federal award program.
 - b. High-level description of the audit scope.
 - c. A grouping of closely related programs sharing common compliance requirements.
 - d. Any external measurement of the federal award program performance.
19. Auditors are required to document specific tasks related to preparing the detailed audit plan. Which of the following is **not** required to be documented under SAS No. 110?
- a. Audit procedure results.
 - b. How the assessed risk procedures are linked to the relevant assertion level.
 - c. A comprehensive documentation of responses to address the assessed risk of material misstatement at the financial statement level.
 - d. The scope of the compliance testing of federal programs.
20. The principal auditor should consider which of the following when deciding whether to make reference to another auditor?
- a. SAS No. 1.
 - b. SAS No. 99.
 - c. SAS No. 109.
 - d. SAS No. 110.
21. Audit sampling is defined by SAS No. 39. According to this definition, the application of the audit procedure must be _____ of the items within an account balance for the purpose of evaluating some characteristic of the balance or class.
- a. > 50%.
 - b. < 75%.
 - c. 75%.
 - d. < 100%.

Lesson 2: Single Audit Sampling

INTRODUCTION

Tests of controls and compliance tests in a single audit may be performed using observation, inquiry, or audit procedures applied to details. These audit procedures may or may not involve the use of sampling. For those instances when sampling is involved, this lesson explains its use and describes an effective approach for each type of audit procedure. Throughout this lesson, unless otherwise noted, the term single audit refers only to the program audit part of the single audit as opposed to the financial statement audit part.

Learning Objectives:

Completion of this lesson will enable you to:

- List the requirements that apply to all single audit samples and explain the objective and purpose of the tests of controls over compliance.
- Identify the steps in planning the audit sample.
- Explain the purpose of compliance tests.
- Describe the auditor's consideration for when assessing the various steps for a nonstatistical sampling approach to substantive tests of compliance.

The Single Audit Act Amendments of 1996, and OMB Circular A-133 do not require statistical sampling. OMB Circular A-133 does require the auditor to apply audit procedures to test whether the internal controls used in administering federal award programs are functioning in accordance with prescribed procedures and to apply audit procedures to test compliance for each major federal program.

In a single audit, the auditor needs to obtain evidence about the entity's compliance with laws and regulations and the provisions of contracts or grant agreements that could have a direct and material effect on a major federal award program. As part of the financial statement audit, the auditor needs to consider the entity's compliance with laws and regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. Neither SAS No. 99 nor OMB Circular A-133 requires separate audit procedures for these tests of compliance. The audit objectives are met when the auditor performs the single audit procedures to test compliance and, therefore, need not be duplicated for financial statement purposes. If instances of noncompliance are discovered during the single audit tests of compliance, however, the auditor should consider the potential effect of the noncompliance on the entity's financial statements and on compliance of the individual federal award program. This lesson focuses primarily on the single audit.

In a single audit, evidence about an entity's compliance with laws and regulations and the provisions of contracts or grant agreements can be obtained by using audit sampling when performing the following:

- Audit procedures to determine if controls used in administering federal award programs are being applied as prescribed (and possibly to reduce the assessed level of control risk and restrict the auditor's substantive tests of compliance related to the awards).
- Substantive tests of compliance for the purpose of rendering an opinion on compliance related to major federal award programs.

The auditor should select transactions for applying audit procedures as part of the tests of compliance of federal award programs. When making these selections the auditor should use professional judgment in determining the method of sample selection as well as sample size. Paragraph 10.33 of the GAS/A-133 AICPA Audit Guide states "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." The auditor's assessment of inherent risk and control risk should be used as the basis for determining sample sizes that will provide sufficient appropriate audit evidence for a conclusion on the compliance requirements for each major program.

Paragraph 10.41 of the GAS/A-133 AICPA Audit Guide explains that 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, 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.

Although the auditor is required to obtain sufficient appropriate audit evidence to support an opinion on compliance for each major program, there is no requirement to use a separate sample for each major program. However, the GAS/A-133 AICPA Audit Guide expresses a preference for selecting separate samples from each major program.

Authoritative Literature

The authoritative pronouncements that establish requirements or provide suggestions that most directly affect the use of audit sampling are as follows:

- SAS No. 39 (AU 350), *Audit Sampling*, as amended by SAS No. 111, *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*.
- AICPA Audit Guide, *Audit Sampling* (the AICPA Sampling Guide).
- OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.
- AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide).

Findings on Sampling from the Single Audit Quality Study. The President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE) released the "Report on National Single Audit Sampling Project" (the Report) in June 2007. Among the Report's findings was that proper sampling techniques had not been applied in many of the single audits reviewed. Specifically, the report noted that inconsistent numbers of transactions were being selected for testing of internal controls and compliance testing for the allowable costs/cost principles compliance requirement. In addition, many auditors did not document the number of transactions and the associated dollars of the universe from which the transactions were drawn. In its most recent Audit Risk Alert, *Government Auditing Standards and Circular A-133 Audits—2008*, the AICPA also indicates that failure to adequately design compliance and control tests, including sampling applications, is a common deficiency found in recent peer reviews of audit firms.

The Report discusses a need to provide for consistency in sample sizes and recommends that OMB and AICPA guidance be amended to require that compliance testing in Single Audits be performed using sampling in a manner prescribed by SAS No. 39, as amended. Among other things, the Report also recommends specific documentation requirements and indicates that guidance should include examples that illustrate proper documentation based on real compliance requirements and situations typically encountered when performing a Single Audit. The Report is available at www.ignet.gov/pande/audit/NatSamProjRptFINAL2.pdf.

The AICPA and OMB have each formed task force groups to respond to the Report's recommendation to provide more specific guidance on sampling in single audits. These projects are expected to result in revisions to the professional standards, AICPA Audit Guides, OMB requirements, and other standards, regulations, and guidance.

Definition of Audit Sampling

Audit sampling is defined by SAS No. 39 (AU 350.01) as—

- . . . the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.

This definition is important in the selection of audit procedures since, by definition, some audit procedures are not sampling. Examples include the following:

- Applying an audit procedure limited to a specific group of items within a balance or class of transactions that have a distinct characteristic; e.g., all transactions (disbursements, expenses, etc.) over \$5,000.
- Examining a few transactions within a balance or class of transactions to obtain an understanding of the nature of the transactions.
- Applying an audit procedure to one or a few transactions to clarify the auditor's understanding of the design of the entity's internal controls.

The important difference in these three examples is that the purpose of the test is not to reach a conclusion that applies to the entire balance or class of transactions. In each of these cases, authoritative pronouncements on sampling would not apply to the test performed.

The definition of audit sampling in SAS No. 39 (AU 350.01) allows some alternatives to sampling in deciding the extent of procedures. This is important since it may allow the auditor to apply procedures in a manner that is more efficient. If audit sampling is used, SAS No. 39 imposes certain requirements. The key to distinguishing audit sampling from other audit approaches for the types of audit tests that might possibly involve sampling is that:

A test involving application of procedures to less than 100 percent of the items in the population but that does not involve projecting the results to the entire account balance or class of transactions *is not audit sampling*.

However, the auditor cannot ignore the requirements of SAS No. 39 by arbitrarily failing to project the results of a sample. Thus, when the auditor evaluates some aspect of an entire account balance or transaction class on the basis of examining less than 100% of the population, the auditor has to follow the requirements of SAS No. 39, and the test results must be projected.

Audit Sampling in Single Audits

Audit sampling in single audits may include both tests of controls and substantive tests of compliance. Controls are tested for two reasons: (a) to support the a low assessed level of control risk for major programs and (b) to obtain appropriate audit evidence about whether internal controls used in administering federal award programs are operating effectively. Tests of controls, tests of compliance, and substantive tests of transactions may be performed simultaneously as a triple-purpose test.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. The President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE) released the "Report on National Single Audit Sampling Project" (the Report) in June 2007. Among the Report's findings was that proper sampling techniques had not been applied in many of the single audits reviewed. Which of the following is true regarding the Report's recommendation on how to provide consistency in choosing sample sizes?
- a. The OMB and AICPA's guidance be amended to require that noncompliance testing in Single Audits be performed using sampling as prescribed by SAS No. 39.
 - b. The report should contain guidance regarding only substantive test of compliance.
 - c. The Report indicates that guidance must include examples that illustrate proper documentation based on actual compliance requirements.
23. Why is it important that auditors have a choice of alternatives when deciding the extent of procedures?
- a. Because of the increased cost that may be associated with sampling.
 - b. Because auditors are sometimes concerned with compliance with specific laws.
 - c. Because only minimal assurance can be obtained from the extent with procedures due to the nature of various specific compliance requirements.
 - d. Because it permits the auditor to utilize certain procedures in a more efficient manner.
24. There are three basic requirements that relate to all single audit samples. Which of the following is **not** one of those requirements?
- a. Defining.
 - b. Applying.
 - c. Selecting.
 - d. Evaluating.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. The President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE) released the "Report on National Single Audit Sampling Project" (the Report) in June 2007. Among the Report's findings was that proper sampling techniques had not been applied in many of the single audits reviewed. Which of the following is true regarding the Report's recommendation on how to provide consistency in choosing sample sizes? **(Page 202)**
- a. **The OMB and AICPA's guidance be amended to require that noncompliance testing in Single Audits be performed using sampling as prescribed by SAS No. 39. [This answer is correct. The Report discusses a need to provide for consistency in sample sizes and recommends that OMB and AICPA guidance be amended to require that compliance testing in Single Audits be performed using sampling in a manner prescribed by SAS No. 39, as amended. The AICPA and OMB have each formed task force groups to respond to the Report's recommendation to provide more specific guidance on sampling in single audits.]**
 - b. The report should contain guidance regarding only substantive test of compliance. [This answer is incorrect. Audit sampling in single audits may include both tests of controls and substantive tests of compliance.]
 - c. The Report indicates that guidance must include examples that illustrate proper documentation based on actual compliance requirements. [This answer is incorrect. The Report indicates that guidance should include examples that illustrate proper documentation based on real compliance requirements and situations typically encountered when performing a Single Audit. Thus, this is a recommendation, not a requirement.]
23. Why is it important that auditors have a choice of alternatives when deciding the extent of procedures? **(Page 203)**
- a. Because of the increased cost that may be associated with sampling. [This answer is incorrect. The increase in cost that may be associated with sampling has encouraged auditors to consider how effective alternative approaches would be before assuming that sampling is necessary.]
 - b. Because auditors are sometimes concerned with compliance with specific laws. [This answer is incorrect. Once an auditor is concerned with compliance of specific laws and regulations, he or she usually regards those categories of items as unusual.]
 - c. Because only minimal assurance can be obtained from the extent of procedures due to the nature of various specific compliance requirements. [This answer is incorrect. Because the nature of several specific compliance requirements identified from analytical procedures offers only minimal assurance, auditors should consider the risk of material noncompliance of the remaining balance and the effectiveness of the analytical procedures.]
 - d. **Because it permits the auditor to utilize certain procedures in a more efficient manner. [This answer is correct. The audit sampling definition in SAS No. 39, allows specific alternatives to sampling when deciding the extent of procedures. By allowing these alternatives, auditors can apply certain procedures in a more efficient manner.]**

24. There are three basic requirements that relate to all single audit samples. Which of the following is **not** one of those requirements? **(Page 201)**
- a. Defining. [This answer is incorrect. The first basic requirement of the single audit sample is defining. Defining is significant in that the auditor must relate the audit procedure objective to the population. In other words, the auditor must define the sampling unit and population.]
 - b. Applying. [This answer is correct. Application is not one of the three requirements that related to all single audit samples. However, this does not mean that application is not an important factor of single audits. Application is mentioned in the definition of audit sampling because the auditor must apply the audit procedures throughout the single audit process as part of the test of compliance for federal award programs.]**
 - c. Selecting. [This answer is incorrect. The second basic requirement of the single audit sample is selection. Selection is significant in that the auditor must select items that he or she expects are representative to the population.]
 - d. Evaluating. [This answer is incorrect. This is the third basic requirement. The auditor needs to project sample results to the population and consider sampling risk.]

REQUIREMENTS THAT APPLY TO ALL SINGLE AUDIT SAMPLES

The two possible approaches to audit sampling are nonstatistical and statistical. SAS No. 39 (AU 350.03) indicates that both of these approaches are capable of producing appropriate audit evidence, if properly applied. In fact, SAS 39 at AU 350.23 observes that, in general, when the same sampling parameters are applied, comparable sample sizes result from either approach. The types of procedures that the auditor applies are not determined by the sampling approach used. Either approach may be used to apply whatever tests of details the auditor deems necessary in the circumstances. The importance of professional judgment cannot be overemphasized as it applies to the evaluation of the sufficiency of audit evidence generated by the sampling approach. Regardless of the sampling approach selected, an auditor needs to properly plan, perform, and evaluate the results of the sample. Professional judgment is needed to relate the sample results to other audit evidence when the auditor forms a conclusion about compliance with laws and regulations. It should be noted, however, that not all tests of compliance or controls are transaction related.

Once an auditor decides to use audit sampling, attention is focused on which sampling approach (statistical or nonstatistical) to use. Substantial information is given in SAS No. 39, as amended by SAS No. 111 the AICPA Sampling Guide, and other sources on the use of various statistical sampling approaches. This section emphasizes using *nonstatistical* sampling.

The Basic Requirements

The basic requirements that relate to all single audit samples—statistical and nonstatistical—are as follows:

- *Defining.* The auditor needs to relate the population to the objective of the audit procedure; i.e., define the population and sampling unit.
- *Selecting.* The auditor needs to select items that can be expected to be representative of the population.
- *Evaluating.* The auditor needs to project sample results to the population and consider sampling risk.

Defining Population and Sampling Unit

Defining the Population. In a single audit sampling application, the population is defined as all items that constitute the account balance or class of transactions, or the portion of the balance or class, being tested (i.e., all expenditures of a certain type for the entity, all expenditures of a certain type for all major programs, all expenditures of a certain type for a specific major program, or all expenditures for a specific major program). The population for a substantive sample usually is the account balance or class of transactions excluding those items selected for testing because of individual significance. The term *individually significant item* encompasses two types of items:

- a. Individually significant dollar items.
- b. Unusual items (that is, items that have audit significance by their nature).

Due to the nature of tests of controls, auditors are ordinarily not concerned with identifying individually significant items when tests of controls are performed using audit sampling.

Sampling results can be projected only to the population from which the sample is drawn. The use of the wrong population for a sampling application could mean that conclusions based on the sample are invalid for an auditor's purpose.

Defining the Sampling Unit. The sampling units are the individual items that are subjected to audit procedures and that represent the components of the population. It is important to properly identify the sampling unit before the sample is selected to produce an efficient and effective sampling application. Examples of sampling units include individual subrecipient grants or contracts, grant expense checks, payroll checks, etc. The determination of the specific sampling unit is influenced by the following considerations:

- The sampling unit should produce an efficient sampling plan.

- The sampling plan must be effective to accomplish its objectives.
- The nature of the audit procedures can determine the sampling unit to be used.

Representative Selection

Selecting Sample Items. The *OMB Circular A-133 Compliance Supplement* (Compliance Supplement) uses the phrase “select a sample” at various locations. SAS No. 39 (AU 350.24), as amended, requires a “representative sample” (that is, the sample items should be selected in such a manner that all items have an opportunity to be selected). The auditor should select a representative number of transactions from each major program but is not required to select separate samples from each major program. There are several commonly used methods of selecting samples in accordance with the guidance in SAS No. 39. The following are some of those methods:

- *Random Selection.* Regardless of the method of sampling used, statistical or nonstatistical, a random selection provides each item in the population an equal chance of being selected.
- *Systematic Sampling.* This method can be used with nonstatistical or statistical sampling to give every item in the population an equal chance of being selected if a random start is used. However, it may not produce an equal opportunity for all combinations of sampling units to be selected unless numerous random starts are made. The population is divided by the number of sample items to determine the sampling interval to use.
- *Haphazard Selection.* Under this method, nonstatistical sample items are selected in no specific pattern without bias for or against any items in the population. This could be done by selecting a sample of items from the paid invoices for the year if there were no bias for or against large ones. The auditor may use this method provided care is taken to be sure no conscious bias is added to the selection process.

An auditor should qualitatively evaluate whether the sample selected seems representative of the population subjected to the audit procedures. For instance, if the auditor is selecting a sample of grant expenditure checks with a sample size of 50, a sample that included 15 employee expense reimbursement checks might not be considered representative of the population subjected to the audit procedures. If the sample does not seem representative, it should be reselected.

The auditor should, if practical, stratify the remaining population. Generally, the remaining population should be divided into at least two subgroups that are more similar in dollar amount. One useful approach to stratification is to base this division on the average amount of an item in the remaining population. All items above the average amount would be one subgroup, and all items below that amount would be the other subgroup.

For all items in the population to have a chance to be selected, the auditor should determine that the sample population actually includes all the items (e.g., participant eligibility files, grant disbursement checks, etc.) comprising the balance. There are many ways to determine the completeness of a sample population, including:

- a. If the sample is selected from a listing (i.e., trial balance, transaction listing), the auditor can foot the listing and reconcile the total to the account balance.
- b. If the items are numerically sequenced, the auditor can scan the accounting records to account for the numerical sequence of items in the population and select the sample from that sequence.

The two sampling forms presented in this lesson both include a step that allows the auditor to document how the completeness of the sample population was considered.

Choosing a Method. The auditor might consider using random selection (with a random number table or computer-generated numbers) or systematic selection when performing nonstatistical sampling. However, using one of these random-based methods does not make the sampling application statistical. Haphazard selection may be used when the population is not numbered or when other circumstances make use of a random-based method impractical.

Projecting Sample Results

The evaluation of sample results has two aspects. The auditor needs to project the noncompliance (or, in a test of controls, calculate the deviation rate). Also, the auditor needs to consider the sampling risk. In a statistical sample, sampling risk is objectively measured using probability theory. In a nonstatistical sample, sampling risk must still be considered and restricted to a relatively low level but cannot be objectively measured precisely. This is the primary conceptual distinction between statistical and nonstatistical sampling. In the two nonstatistical sampling approaches presented in this lesson, sampling risk is assessed by considering whether the rate or amount of exceptions identified in the sample exceed the expected rate or amount of exceptions used in designing the sample.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. Lyndon is performing a single audit of No-pain, No-gain Youth Workout Program. (NPNG) During Lyndon's audit of NPNG; he uses statistical sampling to give each item in the population an equal chance of being selected. Lyndon also divides the population by the number of sample items. Which method of selection/sampling is Lyndon using?
- a. Haphazard selection.
 - b. Random selection.
 - c. Systematic sampling.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. Lyndon is performing a single audit of No-pain, No-gain Youth Workout Program (NPNG). During Lyndon's audit of NPNG; he uses statistical sampling to give each item in the population an equal chance of being selected. Lyndon also divides the population by the number of sample items. Which method of selection/sampling is Lyndon using? **(Page 209)**
- a. Haphazard selection. [This answer is incorrect. If Lyndon uses the haphazard selection method, the nonstatistical sample items would not be selected in any specific order without bias for or against other items in the population.]
 - b. Random selection. [This answer is incorrect. If Lyndon uses the random selection method, whether nonstatistical or statistical, the random selection provides every item in the population an equal chance of being selected.]
 - c. **Systematic sampling.** [This answer is correct. Lyndon uses the systematic sampling method in the example above. Although this method gives each item in the population an equal chance of being selected if a random start is used, it may not produce an equal opportunity of all combinations of sampling units to be selected unless numerous random starts are made.]

TESTS OF CONTROLS OVER COMPLIANCE

Irrespective of the fact that tests of controls are required by OMB Circular A-133, there are basically two purposes of tests of controls in a single audit:

- To determine and to report on whether the entity has internal controls to provide reasonable assurance that it is managing federal award programs in compliance with applicable laws and regulations and the provisions of contracts or grant agreements.
- To obtain a reduced control risk assessment in order to reduce the extent of substantive tests of compliance.

Objective of the Tests

The primary objective of tests of controls in a single audit is to determine whether the entity has internal control systems in place to provide reasonable assurance that it is managing federal award programs in compliance with the provisions of laws, regulations, and contracts or grants that have a direct and material effect on each major program [the Single Audit Act Amendments of 1996, Section 7502(e)(4)]. OMB Circular A-133, Section 500(c)(2) and Paragraph 10.29 of the GAS/A-133 AICPA Audit Guide, indicate that it is the auditor's responsibility to perform tests of these controls. To accomplish this, 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.
- Perform testing of controls as planned.

This process of testing internal controls and assessing control risk also provides audit evidence evidential matter about the risk that material noncompliance exists in a major program and may permit the auditor to reduce his or her substantive tests of compliance.

Purpose of the Tests

Section 500(c) of OMB Circular A-133 requires that the auditor perform tests of controls. The purpose of those tests is to evaluate the effectiveness of the design and operation of internal controls, applicable to each major federal award program, that the auditor considers relevant to preventing or detecting material noncompliance with the applicable compliance requirements. The auditor is generally required by OMB Circular A-133 to perform such tests regardless of whether he or she would otherwise choose to obtain evidence to support an assessment of control risk below the high. The only exception to the requirement to test controls is those areas where controls are likely to be ineffective. The Circular makes it clear, though, that, in such a case, the internal control report should include the internal control deficiency related to the control(s) not tested.

Triple-purpose Tests

When performing single audits, the auditor may use a test of transactions to combine substantive compliance tests over major programs that involve the inspection of supporting documentation with substantive tests of transactions to support amounts recorded in the financial statements or tests of control activities used in administering federal award programs. In other words, a *triple-purpose test of transactions* is possible. The auditor selects a sample of transactions and inspects supporting documentation to determine the following:

- a. Indications of compliance with relevant, laws, regulations, and compliance requirements.
- b. Recorded in correct amount, account, and period.
- c. Indications of performance of internal controls.

When this approach is taken, the sample size should be the largest sample size necessary to satisfy any one of the three purposes of the test.

Terminology for Sampling in Tests of Controls

The following discussion uses the following sampling terms:

- *Deviation*—Departure from the prescribed control policy or procedure.
- *Tolerable Rate*—The maximum rate of deviations that would still support the planned assessed level of control risk.
- *Risk of Assessing Control Risk Too Low*—The auditor's allowable risk of assessing control risk too low, as aspect of sampling risk. (If control risk is assessed too low, the auditor may inappropriately rely on a control. Thus, this risk is also called the risk of overreliance.)
- *Expected Rate*—The rate of deviations the auditor expects based on prior experience and knowledge of the characteristics of the population.
- *Population*—The class of transactions being sampled.

The basic approach to applying tests of controls is the same regardless of whether sampling is used. However, there are additional matters to consider when using audit sampling methods. Exhibit 2-1 illustrates how those additional considerations are integrated into the basic approach to testing controls. This lesson discusses those additional considerations and how they affect tests of controls.

Exhibit 2-1

Tests of Controls Using Audit Sampling

- | | |
|---------------|---|
| Step 1 | Identify suitable controls to be tested and consider whether any related substantive compliance tests may be reduced. |
| Step 2 | Consider whether testing controls is practical. ^a <ol style="list-style-type: none"> 1. Consider whether there is documented evidence of the application of the controls. 2. Consider whether controls are likely to be effective. |
| Step 3 | Select appropriate tests of controls. <ol style="list-style-type: none"> 1. Define "deviation" for purposes of the test. 2. Define the population to be sampled. 3. Determine the tolerable rate of deviations. 4. Determine the allowable risk of assessing control risk too low (risk of overreliance). 5. Determine the expected rate of deviations. 6. Determine the sample size. 7. Determine the method of sample selection. |
| Step 4 | Perform tests of controls. <ol style="list-style-type: none"> 1. Select sample and apply audit procedures to the sample. |

Step 5 Evaluate the results of the tests of controls.

1. Compare sample rate of deviations to tolerable rate of deviations and consider the effect of sampling risk.

Step 6 Assess control risk.

Step 7 Document the tests performed and conclusions reached.

Note:

- ^a The auditor's decision regarding the practicality of testing controls is not based on whether testing controls is cost-effective since OMB Circular A-133 requires tests of controls.

* * *

Step 1—Identifying Controls and Related Substantive Compliance Tests

The first step in planning the sample is to identify the controls to be tested and consider whether any related substantive compliance procedures may be reduced. Paragraph 6.34 of the GAS/A-133 AICPA Audit Guide encourages auditors to “take advantage” of the OMB Circular A-133 requirement to plan tests for a low assessed level of control risk (providing a low risk level is achieved) when performing substantive compliance procedures. This step requires identifying controls relevant to specific assertions that are likely to prevent or detect material misstatements or noncompliance in those assertions. The identification of controls is not changed by use of audit sampling. However, only certain types of controls are generally susceptible to testing using sampling.

Audit sampling can be used to perform tests of controls over the compliance requirements similar to the way that audit sampling is used to perform tests of other types of internal controls. In practice, the most common test of controls *that uses audit sampling* is a test of transactions. However, not all tests of controls involve the use of audit sampling. Generally, audit sampling is only used for tests of controls where there is documentation of the operation of the controls. Normally, these tests of controls involve inspection of documents and reports indicating performance of the control activity and, in many cases, reperformance of the application of the activity. For example, the most common type of control activity tested is a checking routine or approval evidenced by initials, signatures, or stamps on documents. The approach is usually to sample the documents, inspect items selected for evidence of performance of the control activities, and reperform the procedure to test its effectiveness.

Step 2—Considering Whether Testing Controls Is Practical

OMB Circular A-133 requires the auditors to test controls unless such controls are likely to be ineffective. Thus, testing of controls may not be omitted for audit cost effectiveness reasons simply because it will not restrict substantive tests. When sampling is used in tests of controls, the auditor should also consider whether there is documented evidence of the application of the identified controls (such as rubber stamps, initials, matched source documents, etc.). Without documented evidence, it may be difficult to test those controls using audit sampling.

Steps 3 and 4—Selecting and Performing Tests of Controls

As discussed in the preceding paragraph, documented controls are normally susceptible to testing through sampling. A common type of control activity tested is a checking routine or approval evidenced by initials, signatures, or stamps on documents. The approach is usually to sample the documents, inspect items selected for evidence of performance of the control activities, and reperform the procedure to test its effectiveness. As shown in Exhibit 2-1, selecting tests of controls when sampling is used involves many considerations besides the type of test procedure.

Define the Population and Deviations. For a test of controls using audit sampling, the auditor may define the population in one of two ways. Since a particular control activity often is applicable to the items of more than one

major program, the auditor may (a) define the items from each major program as a separate population or (b) define all items to which the control is applicable as a single population. The size of the population has little or no effect on sample size; therefore, it usually will be more efficient to select one sample from all the items to which the control is applicable.

The sample units in these circumstances are individual transactions of a particular type, and the auditor needs to specify the physical sample unit that will be selected; e.g., canceled checks when the population is cash disbursements. Also, the auditor needs to specify the conditions that will be regarded as deviations from prescribed internal controls.

Determine the Tolerable Rate of Deviations. Deciding on the appropriate tolerable rate is strictly an audit judgment. All sampling does is force the auditor to specify in advance what rate of deviation would correspond to the levels of control risk to be used, e.g., high, moderate, or low. How many deviations from a key control would the auditor tolerate before changing from low risk to moderate risk or moderate to high? Examples of tolerable rates commonly used in practice are as follows—

Planned Assessed Level of Control Risk	Tolerable Rate
Low	5–7%
Moderate	10–12%
High	Omit Test

The tolerable rates used in practice are generally higher than most “textbook” illustrations of attribute sampling. The reasons for the higher rates are that (a) the deviation rate is expected to be higher than the monetary misstatement rate (a deviation from a control does not automatically mean there is a monetary misstatement) and (b) some substantive procedures will be applied to detect monetary misstatement. SAS No. 110 (AU 318.09) states that “regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure . . .”

Determine the Allowable Risk of Assessing Control Risk Too Low (Risk of Overreliance). This risk is similar to the risk of incorrect acceptance in a substantive sample. This means that it—

- a. is an aspect of *sampling risk*, and
- b. has a corresponding opposite risk (the risk of assessing control risk too high), which does not have to be considered under authoritative pronouncements because it relates solely to efficiency.

Authoritative pronouncements are more specific about allowable risk than tolerable rate. SAS No. 39 (AU 350.37), as amended, explains that when a test of controls using audit sampling is the primary source of evidence of whether the procedure is being applied as prescribed, the auditor should allow for a low level of sampling risk (i.e., the risk of assessing control risk too low). Footnote 13 to AU 350.37 even specifies how low: “The auditor who prefers to think of risk levels in quantitative terms might consider, for example, a 5 percent to 10 percent risk of assessing control risk too low.” Generally, the risk level is fixed at 10% in practice. This means there is 90% assurance that the auditor is not assessing control risk too low or overrelying on controls. A 10% sampling risk is allowed because the auditor never places complete reliance on the control risk assessment. In statistical theory, either the risk or the tolerable rate could be varied in response to the assessed level of control risk. However, changing the risk does not fit audit logic. The tolerable rate is more directly related to the risk of monetary misstatement.

Determine the Expected Rate of Deviations. The auditor should also consider the expected rate of deviation from a particular control. Generally, if the expected rate is over one-half the tolerable rate, sampling is not efficient. However, if the expected rate is high, the auditor would not plan to assess control risk below the high level. In practice, many tests of controls using sampling plans assume a zero expected rate. This is analogous to the statistical method of discovery sampling, and it is highly efficient. The established tolerable rate, allowable risk of assessing control risk too low (risk of overreliance), and expected rate are the only factors that need to be specified

for determining sample size in a statistical sample size table. For example, Table A.2 in the AICPA Sampling Guide gives sample sizes for a 10% sampling risk.

Determine the Sample Size. In determining the sample size for a test of controls, SAS No. 39 states that the auditor should consider the tolerable rate, the risk of assessing control risk too low (risk of overreliance), and the expected rate of deviations from prescribed controls. The only relevant population characteristic is usually the expected rate of deviations. Population size is usually assumed to be infinite for convenience. Only very small population sizes would influence sample size, and the difference is normally insignificant. Generally, if the population is smaller than 2,000 items, the conclusions are conservative, i.e., characteristics of the population are actually better than the statistical evaluation indicates, but there is little efficiency to be gained by reducing the sample size until the population falls below approximately 200 items. However, if the population is less than 200 items, the auditor should be aware that sample sizes in statistical sampling tables or nonstatistical sampling approaches based on statistical methods may have a larger than necessary sample size. In other words, the sample size is effective, but not efficient. Therefore, this course provide sample sizes for three ranges of population size: greater than 200, 100–200, and less than 100.

Auditors should use professional judgment when combining the evidence obtained from tests of controls using audit sampling with evidence from other tests of controls that do not involve audit sampling (e.g., inquiry and observation). In the auditor's judgment, the combined evidence must be sufficient to determine whether the entity has controls in place to provide reasonable assurance that it is managing its federal award programs in compliance with the applicable laws and regulations and the provisions of contracts or grant agreements. In making this judgment, the auditor should consider the following:

- The nature of the controls.
- The importance of the controls in ensuring compliance.
- The type and extent of any tests of the effectiveness of the controls performed by the entity.

Practical Guidance on Sample Size

An approach to sampling for tests of controls has been developed that allows effective and efficient determination of sample size and evaluation of sample results. This approach is based on the statistical theory of attribute sampling, but it does not require specialized statistical knowledge or training. This approach uses tolerable rates, a 10% risk of assessing control risk too low (risk of overreliance) (90% confidence or assurance level) and a zero expected deviation rate. That means when there is greater than a 10% risk that the deviation rate in the population exceeds approximately 12%, control risk is assessed as high (that is, the auditor did not achieve a low level of assessed control risk). The recommended approach to sample size determination is presented in Exhibit 2-2.

Exhibit 2-2

Determination of Sample Size for a Test of Controls

Sampling Table Based on Population Size—90% Confidence Level

Population Size	Sample Size		
> 200	25	40	60
100–200	22	35	50
< 100	20	30	45
Number of Deviations (Expected or Actual)	Control Risk Assessment		
0	Moderate	Low	Low
1	High	Moderate	Low
2	High	High	Moderate
3	High	High	Moderate

Example: If the population size is 125 and the auditor expects to find one deviation, the auditor would plan to sample 50 items to reduce the control risk assessment to low. When evaluating the sample, if the auditor actually found two deviations, the sample results would support a control risk assessment of moderate.

* * *

.Because of the single audit requirement to plan tests of controls to support a low assessed level of control risk, the sample should not be less than 40 for a population greater than 200, less than 35 for a population of 100–200, or less than 30 for a population less than 100, if based on the above table. For example, if the auditor believes the sample results may include a single deviation, then a sample size of 60 would be necessary for a population greater than 200. Note that a sample size of 25 for a population greater than 200 with no deviations will at best support an assessed level of control risk of moderate. If one or more deviations are found, control risk will have to be assessed at as high. This occurs because of the high sampling risk associated with a small sample size. A single deviation in a sample of 25 for a population greater than 200 is an actual deviation rate of 4%. However, at a 10% risk of assessing control risk too low, the true deviation rate in the population could be as high as 15%, and there is a 10% risk that it is higher.

A Sample of 40. For a population greater than 200, the auditors approach generally involves a choice between sample sizes of 40 or 60 items, depending upon the auditor's judgment about risk. The auditor should make an overall judgment based on the expected number of deviations and the planned assessed level of control risk before deciding whether to select a sample of 40 or 60 items. Because of the requirement to plan the test of controls to support a low control risk level, the sample size for a population greater than 200 will generally be 40 if the planned number of deviations is zero, or 60 if the planned number of deviations is one.

When a low assessed level of control risk cannot be supported, the auditor may, but is not required to, increase the sample size. The AICPA Sampling Guide indicates that a rule-of-thumb for expanding sample size when deviations are found is to at least double the sample size. If no additional deviations are found, the auditor can support the planned control risk. Instead of expanding the sample size, the auditor could choose to assess control risk at other than low, design tests of controls accordingly, and consider the need to report an audit finding. However, if the auditor decides to increase the sample size, the decision should be based on whether the auditor considers the additional internal control testing to be more efficient than performing additional tests of compliance. This will generally not be the case except when there is a large number of major grants, and the auditor is relatively sure the additional testing will result in a lower control risk assessment.

A Sample of 25. Many practitioners have asked if they can use a sample size of 25 for a population greater than 200 to test controls. It should be noted that a determination of sample size is a matter of professional judgment, and SAS No. 39 does not require the auditor to compare the sample size for a nonstatistical sampling application with a corresponding sample size calculated using statistical theory. SAS No. 39 (AU 350.23), as amended by SAS No. 111, states as follows:

An auditor who applies nonstatistical sampling uses professional judgment to relate these factors in determining the appropriate sample size. Ordinarily, this would result in a sample size comparable to the sample size resulting from an efficient and effectively designed statistical sample, considering the same sampling parameters.

The auditor will need to apply careful professional judgment in reviewing the risk levels and expected deviation rates in relation to the sample sizes to meet the requirements of Circular A-133.

In statistical theory, either the confidence level or the tolerable error rate can be varied in response to the assessed level of control risk. Or stated differently, as the sample size decreases, either the confidence level decreases or the tolerable error rate increases for a given level of control risk assessment. Because it is not believed that it is logical for the risk of assessing control risk too low (risk of overreliance) to be greater than 10% (less than a 90% confidence level), the question becomes, what is the effect on the tolerable error rate? With a sample of 25 and no deviations, there is a 10% risk that the deviation rate will exceed 9%. With one or two deviations, there is a 10% risk that the error rate will exceed 15% or 20% respectively. Based on a 95% confidence level, a sample of 25, and zero,

one, or two deviations, there is a 5% risk that the error rate will exceed *approximately* 12%, 18%, and 25% respectively.

The maximum rate that is allowable to still assess the control risk as low is a matter of professional judgment. It is believed that an auditor may make his or her own judgment, and that judgment can vary from situation to situation. For example, if four procedures contribute to control over a transaction and all four are being tested (by inquiry, observation, or inspection), it might be reasonable to accept a higher deviation rate for one of the procedures and still assess overall control risk as low. It would be a matter of judgment and would depend on what the procedures are, and the nature of the deviation. Just how high the accepted error rate could go is strictly a matter of judgment.

One Sample from Each Internal Control System. The auditor usually will need to select a sample from each internal control system or subsystem. The auditor must be sure that all of the significant controls, as determined by the auditor are tested. The tests of the sample will be in addition to the tests of controls performed through inquiry and observation for those controls that do not provide documentary evidence of their performance. The auditor should note that if this test is designed as a triple-purpose test the compliance aspect of the test would only relate to those programs from which items were selected for triple-purpose testing; whereas, if the entity has only one internal control process, the control part of the test would apply to all programs.

As indicated above, only one sample need be selected from each internal control system or subsystem. For example, if all major programs are under one control system, only one test of control sample need be selected. Also note that if a dual-purpose (or triple-purpose) test is being performed covering more than one major program, the substantive test can count toward the test of control sample.

Population Is Less Than 100. As a general rule, sampling may not be efficient when the population is less than 100. In these instances, it is believed that when a test of transactions is required, it may not be necessary to select a sample. In some situations, it is believed a double (or triple) purpose test using a judgmental test size based on the judgment of the auditor (rather than statistical or nonstatistical sampling) may be sufficient when combined with observation and inquiry procedures.

Infrequently Operating Controls. A special case of small population size is a control that operates infrequently. For example, controls over a bank reconciliation operate monthly or twelve times a year and controls over a weekly payroll operate 52 times a year. The AICPA Sampling Guide (Paragraph 3.61) provides reasonable minimum sample sizes related to the frequency of operation of controls as illustrated in Exhibit 2-3. The guidelines are based on the experience and judgment of practicing auditors rather than being statistically derived.

Exhibit 2-3

Minimum Sample Sizes for Infrequently Operating Controls

Control Frequency and Population Size	Sample Size
Quarterly (4)	2
Monthly (12)	2–4
Semimonthly (24)	3–8
Weekly (52)	5–9

* * *

The sample sizes in Exhibit 2-3 are based on the assumption that the test of controls being performed is supplemented by other sources of evidence, such as a walkthrough, corroborating inquiries, past experience with the competence and diligence of the personnel, or other control testing. Also, the testing is assumed to be for one or a few locations. For example, a weekly control performed at 50 locations would represent a population of 2,600, which would be a large population.

Determine the Sample Selection Method

The sample selection methods are appropriate for tests of controls using audit sampling. It should be emphasized, however, that block sampling (i.e., selecting all the transactions of a particular type for a day, week, or month) is not acceptable. A distinctive aspect of selecting a sample for a test of controls is that if any documents necessary to perform the test are missing, the item normally has to be counted as a deviation. According to the following SAS No. 39 as amended (AU 350.40) statement:

If the auditor is not able to apply the planned audit procedures or appropriate alternative procedures to selected items, he should consider the reasons for this limitation, and he should ordinarily consider those selected items to be deviations from the prescribed policy or procedure for the purpose of evaluating the sample.

However, unused and legitimately voided documents do not have to be considered as deviations.

Step 5—Evaluating the Results of Tests of Controls

The table in Exhibit 2-2 can be used both to determine sample size during planning and to evaluate sample results. The table incorporates the consideration of sampling risk. The auditor needs to consider the effect of sampling risk, i.e., the risk that the true rate of deviation in the population may be higher than the projected rate. The auditor cannot simply compare the projected rate of deviation to the tolerable rate and assess controls as effective if the projected rate is lower. If the table is not used, the auditor needs to judgmentally consider the risk that the true rate of deviation may differ from the sample rate. For example, if the auditor wants to assess control risk as low for a population of 2,000 items and believes the sample results may include a single deviation, then a sample size of 60 would be necessary. If more than one deviation is found in the sample, then the assessed level of control risk would be at best moderate. Note that a sample size of 25 with no deviations for a population of 2,000 items will at best support an assessed level of control risk of moderate. This occurs because of the high sampling risk associated with a small sample size. A single deviation in a sample of 25 is an actual deviation rate of 4%. However, at a 10% risk of assessing control risk too low, the true deviation rate in the population could be as high as 15%, and there is a 10% risk that it is higher. While OMB Circular A-133 requires the auditor to plan the audit to support a low assessed level of control risk for major programs, a low level of risk may not be achieved.

Practical Implications If Deviations Are Found. One practical implication of the table in Exhibit 2-2 is that if the auditor finds more than three deviations when the audit procedure is applied to the first few selected items, the auditor should stop and assess control risk as high. Auditors often ask: If a deviation is found, can the sample size be increased so that assessment of control risk at less than high is possible if no more deviations are found? The answer is a qualified yes. The AICPA Sampling Guide (Paragraph 3.63) observes that a practical and conservative rule-of-thumb for expanding sample size when deviations are found is to at least double the sample size. If no additional deviations are found, the auditor can support the planned control risk assessment. The AICPA Sampling Guide (Paragraphs 3.79–81), however, also cautions the auditor that extending the sample when the initial sample was indicative of the true error rate will likely result in further deviations being identified. For that reason, and because the writers of this course believe that sample sizes of over 60 are inefficient, the writers of this course discourage expanding the sample when unexpected deviations are found. It makes more sense for the auditor to increase the extent of substantive procedures and not attempt to restrict substantive procedures by assessing control risk as low or moderate. In using the table, it is important to remember that the sample results only indicate the satisfactory functioning of a control procedure that the auditor has judgmentally concluded is effective as designed. The initial judgment that the design of the control activity permits restricting the extent of substantive procedures if the control activity functions effectively is strictly an audit judgment.

Step 6—Assessing Control Risk

Essentially, assessing control risk involves applying the evaluation of the test (Step 5) to the assertions they were matched with in Step 1. SAS No. 110 (AU 318.72) states that the auditor should determine whether the audit evidence obtained from the test of controls—

- provides a basis for reliance on the controls tested,
- indicates the auditor should perform additional tests of controls, or
- indicates the auditor needs to address the potential risk of material misstatement through substantive procedures.

For controls that are determined to be effective, control risk for the related assertions is assessed as moderate or low, depending on the sufficiency and appropriateness of the evidence obtained. Control risk is assessed as high for remaining assertions because either (a) no related tests of controls were performed or (b) the related controls were tested and determined to be ineffective. Using the table in Exhibit 2-2, the auditor can determine the appropriate level of control risk given the sample size and number of deviations in the sample.

Step 7—Documenting Samples for Tests of Controls

When using audit sampling for tests of controls, the auditor should consider the documentation requirements of SAS Nos. 39, 103, and 109. SAS No. 109 at AU 314.122 requires the auditor to document the assessment of the risks of material misstatement (which is a combination of control risk and detection risk at the relevant assertion level) both at the financial statement level and at the relevant assertion level as well as the basis for the assessment. SAS No. 103, *Audit Documentation*, indicates that auditors performing tests of operating effectiveness of controls involving inspection of documents should include in the workpapers identifying characteristics of the items tested. A walk-through ordinarily is not a test of the operating effectiveness of controls. However, the auditor's documentation, which ordinarily is in the form of a memo, should indicate which transaction(s) were selected for walk-through. For reperformance tests involving review of reconciliations and similar recordkeeping routines, it is believed documentation should identify which routines were reperformed and the nature of the auditor's tests. SAS No. 39 does not impose specific documentation requirements for audit sampling, however, the AICPA Sampling Guide at Paragraph 3.93 indicates that auditors typically document the following matters:

- A description of the control being tested.
- The control objectives related to the sampling application, including the relevant assertions.
- The definitions of the population and the sampling unit, including how the auditor considered the completeness of the population.
- The definition of the deviation condition.
- The acceptable risk of overreliance on controls (or desired confidence or assurance level), the tolerable deviation rate, and the expected population deviation rate used in the application.
- The method of sample-size determination.
- The method of sample selection.
- The selected sample items.
- A description of how the sampling procedure was performed.
- The evaluation of the sample and of the overall conclusion.

When matters, such as sample size determination or expected deviation rate, are implicit in the tables or forms used in a firm's sampling approach, those matters need not be separately documented. The lack of documentation of

sampling is one of the most common topics in letters of comments for peer reviews. Both AICPA standards and the Yellow Book state that the audit documentation should be sufficient to enable an experienced auditor with no connection with the audit to understand the nature, timing, extent, and results of the audit procedures performed. In addition, SAS No. 103, *Audit Documentation*, states that documentation of audit procedures, including those involving sampling, should include identifying characteristics of the specific items that were tested. This requirement specifically includes tests of the operating effectiveness of controls and substantive tests of details involving inspection of documents. SAS No. 110 (AU 318.77) states that the auditor should document the nature, timing, and extent of the further audit procedures (the test of control in this instance) and the linkage of those procedures to the assessed risks at the relevant assertion level. Thus, the audit documentation should document all important aspects of the engagement, including the sampling and other selection criteria used, and should be sufficiently detailed to permit reasonable identification of the work done and conclusions reached.

Relating Program Audit Procedures to Financial Audit Procedures

The ideal approach to the single audit would be to perform both parts of the audit simultaneously so that efficiency could be maximized when testing transactions or controls. This, however, is not always practical or possible since different staff members may conduct the financial and the program compliance parts of the single audit.

Even if the financial and program compliance parts of the audit are not conducted simultaneously, the auditor must consider the effects on the financial statement audit of any findings or questioned costs identified in the program part of the single audit. Likewise, the audit of the federal award programs should be able to take advantage of the results of audit procedures performed in auditing the basic financial statements of the entity. For example, if the auditor determines that testing controls to reduce the assessed level of control risk over a particular audit area is appropriate for the financial statement audit, the auditor may be able to reduce substantive tests of compliance in the program part of the audit for those areas where controls have been determined to be effective. The auditor may also be able to reduce substantive tests of compliance where the tests of controls required by the single audit indicate that controls are effective and the control risk assessment can be reduced below high. Care should be exercised when attempting to utilize the results of audit tests in the financial part of the single audit to reduce testing in the program compliance part of the audit because of the differences in the audit objectives of the two parts.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

26. What is the first step in testing controls?
- a. Assessing the effectiveness of the design and operation of internal controls.
 - b. Determining if any noncompliance exists that could have a major impact on the financial statements.
 - c. Determining if the organization has internal control systems in place.
27. Regarding sampling in tests of controls, which of the following is based on prior experience?
- a. Monetary misstatement.
 - b. Expected.
 - c. Tolerable.
28. The firm of Winters & Somers has accepted an engagement of their client Helios Foundation, and is planning a sample of tests of controls. What is the firm's first consideration in planning the sample?
- a. Perform tests of controls.
 - b. Select the tests of controls.
 - c. Assess the control risk.
 - d. Identify the controls to be tested.
29. Which of the following is **not** one of the seven steps in testing controls using audit sampling?
- a. Determine if the entity has internal controls systems in place.
 - b. Consider if testing is practical.
 - c. Assessing control risks.
 - d. Identify controls and related compliance tests.
30. Which of the following statements regarding selecting and performing tests of controls is most accurate?
- a. The larger the population; the larger the sample size should be.
 - b. The AICPA Audit Guide, *Audit Sampling* (the AICPA Sampling Guide) provides a list of tolerable rates for auditors to use for sampling.
 - c. The auditor has two choices when defining the population.
 - d. The general textbook tolerable rate examples reflect higher tolerable rates than used in practice.

31. David, an experienced auditor, is auditing Anytown U.S.A., a governmental unit. David is testing controls for this entity, and needs to document how he arrived at the samples. Which of the following statements accurately reflects David's obligation when documenting samples he used for testing controls?
- a. David must document the risk of material misstatement which is solely based on control risks.
 - b. David should perform the standard walk through to test the operating effectiveness of the controls.
 - c. David must conform to specific documentation requirements as identified in SAS No. 39.
 - d. David's documentation should allow his peer, Susan, who is not involved in the engagement to understand the audit procedures performed.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

26. What is the first step in testing controls? **(Page 213)**
- a. Assessing the effectiveness of the design and operation of internal controls. [This answer is incorrect. Assessing the effectiveness of the design and operation of internal controls applicable to each major federal award program is the purpose of the tests of controls, not the main objective.]
 - b. Determining if any noncompliance exists that could have a major impact on the financial statements. [This answer is incorrect. When auditors perform a compliance test, the objective is to furnish a basis for providing an opinion on the major programs and determine if any noncompliance exists that could have a major effect on the financial statements.]
 - c. **Determining if the organization has internal control systems in place. [This answer is correct. An auditor must first determine if an organization's internal control systems are being implemented to provide reasonable assurance that the organization is managing federal award programs in compliance with the requirements of laws, regulations, and contracts or grants that directly affect each major program.]**
27. Regarding sampling in tests of controls, which of the following is based on prior experience? **(Page 214)**
- a. Monetary misstatement. [This answer is incorrect. The monetary misstatement rate is a deviation from a control does not automatically mean there is a monetary misstatement.]
 - b. **Expected. [This answer is correct. This is the rate of deviations that an auditor expects based on prior experience and knowledge of the population's characteristics.]**
 - c. Tolerable. [This answer is incorrect. The tolerable rate is the maximum deviation rate that would still support the planned assessed level of control risk.]
28. The firm of Winters & Somers has accepted an engagement of their client Helios Foundation, and is planning a sample of tests of controls. What is the firm's first consideration in planning the sample? **(Page 215)**
- a. Perform tests of controls. [This answer is incorrect. This is the second step when planning the sample.]
 - b. Select the tests of controls. [This answer is incorrect. Winters & Somers would perform this task during the third step of the planning process.]
 - c. Assess the control risk. [This answer is incorrect. Assessing the control risk is step 6 of the planning process.]
 - d. **Identify the controls to be tested. [This answer is correct. Identifying the controls to be tested is the first step in planning the sample. Winters & Somers must identify the controls to be tested and consider if any related substantive compliance procedures can be reduced.]**
29. Which of the following is **not** one of the seven steps in testing controls using audit sampling? **(Page 215)**
- a. **Determine if the entity has internal controls systems in place. [This answer is correct. This is not one of the seven steps. Determining if the entity has internal control systems in place to provide reasonable assurance that the entity manages its federal awards programs in compliance with regulation is the primary objective in a single audit.]**
 - b. Consider if testing is practical. [This answer is incorrect. This is the second step in the process of testing internal controls.]

- c. Assessing control risks. [This answer is incorrect. This is the sixth step in the process once the testing has been completed.]
 - d. Identify controls and related compliance tests. [This answer is incorrect. This is the first step in the process of testing controls using audit sampling.]
30. Which of the following statements regarding selecting and performing tests of controls is most accurate? **(Page 215)**
- a. The larger the population; the larger the sample size should be. [This answer is incorrect. Generally, it is better to choose one single sample from all the items to which the control is applicable because the size of the population has no or little effect on the sample size.]
 - b. The AICPA Audit Guide, *Audit Sampling* (the AICPA Sampling Guide) provides a list of tolerable rates for auditors use for sampling. [This answer is incorrect. Auditors must use their own judgment when deciding on the appropriate tolerable rate. Sampling forces auditors to determine in advance the deviation rate and how it corresponds to the levels of control risk to be used. Examples of these levels are high, moderate, and low.]
 - c. **The auditor has two choices when defining the population. [This answer is correct. Because a specific control activity usually is applicable to the items of more than one program, the auditor has the choice of either defining all items to which the control is applicable as a single population or defining each major program's items as individual populations.]**
 - d. The general textbook tolerable rate examples reflect higher tolerable rates than used in practice. [This answer is incorrect. Generally, tolerable rates used in practice are higher than those illustrated in textbooks.]
31. David, an experienced auditor, is auditing Anytown U.S.A., a governmental unit. David is testing controls for this entity, and needs to document how he arrived at the samples. Which of the following statements accurately reflects David's obligation when documenting samples he used for testing controls? **(Page 221)**
- a. David must document the risk of material misstatement which is solely based on control risks. [This answer is incorrect. Risks of material misstatement are a combination of control risk and detection risk.]
 - b. David should perform the standard walk through to test the operating effectiveness of the controls. [This answer is incorrect. A walk through is not ordinarily considered a test.]
 - c. David must conform to specific documentation requirements as identified in SAS No. 39. [This answer is incorrect. The Audit Guide provides suggestions not specific requirements.]
 - d. **David's documentation should allow his peer, Susan, who is not involved in the engagement to understand the audit procedures performed. [This answer is correct. According to the AICPA standards and the Yellow Book the audit documentation should be sufficient to enable an experienced auditor who is not connected to the audit to understand the nature, timing, extent, and results of the audit procedures, including those involving sampling.] (Page 221)**

SUBSTANTIVE TESTS OF COMPLIANCE

Compliance with laws and regulations and the provisions of contracts or grant agreements is necessary for an entity to recognize an amount as revenue earned or to receive reimbursement for an expense from a grantor agency. Therefore, compliance with laws and regulations and the provisions of contracts or grant agreements has a direct effect on line-item amounts in the financial statements of a governmental unit or nonprofit organization. Also, OMB Circular A-133 requires the auditor to test an entity's compliance with compliance requirements, noncompliance with which could have a direct and material effect on the program. These substantive tests of compliance may or may not involve the use of audit sampling.

Substantive Tests of Transactions

Substantive tests of transactions in a single audit usually relate to major program compliance with laws, regulations, contracts, and grant agreements. The purpose of compliance tests is to determine whether any noncompliance exists that could have a material effect on the financial statements and to provide a basis for providing an opinion on major programs. As a result, tests of compliance are considered substantive tests that usually are achieved by examining supporting documentation. In a single audit, this type of audit test is frequently applied using audit sampling in much the same manner as other types of substantive tests.

OMB Circular A-133, Section 500(d), describes the single audit requirement for the auditor to test compliance in order to determine whether the recipient has complied with laws and regulations, contracts, and grant agreements that may have a direct and material effect on each major federal award program. Paragraph 6.34 of the GAS/A-133 AICPA Audit Guide addresses the opportunity for auditors to reduce substantive tests of compliance and increase audit efficiency because of OMB Circular A-133's internal control testing requirements, as follows:

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.

The auditor may be able to perform compliance testing for major programs concurrently with tests of controls (that is, dual purpose testing). However, the internal control tests and compliance tests should be distinguished from each other so there is clear documentation to support both types of tests and the separate conclusions reached on both internal control and compliance.

When Is Audit Sampling Appropriate?

The Compliance Supplement identifies program requirements and suggests audit procedures for the 14 types of compliance requirements. However the Compliance Supplement does not specify the extent of testing required. Instead, the auditor uses professional judgment to determine the extent of the tests of compliance by considering several factors, including the results of tests of the controls used to administer federal award programs.

By their nature, some compliance requirements lend themselves to sampling. Such requirements leave documentary evidence of compliance and involve large populations. Others, because of the small population involved or the type of evidence of compliance available, do not lend themselves to sampling. Compliance requirements that typically include sampling for at least a portion of the testing include activities allowed or unallowed; allowable costs/cost principles; eligibility; and procurement, suspension, and debarment. The Davis-Bacon Act and real property acquisition and relocation assistance compliance requirements may lend themselves to sampling if the number of transactions is large enough. Other requirements may involve sampling in certain instances.

Defining the Population

The population for a test of compliance usually consists of a class of transactions that are subject to the requirements of a particular law or regulation or the expenditures for a specific major program. The dollar amounts of these transactions may vary significantly; therefore, the auditor should consider such variation when determining an appropriate sample size for the test. When audit sampling is involved, the auditor should use judgment in defining the audit population.

Determining Sample Size

Sample size should be determined by the auditor using professional judgment and taking into consideration the assessment of inherent risk and control risk. The objectives of auditing procedures for federal award programs are to provide sufficient, appropriate audit evidence to reasonably assure the detection of material noncompliance with compliance requirements applicable to major federal programs. Therefore, the auditor should select sample sizes that will provide appropriate evidence for that purpose. While reiterating the fact that the auditor should use professional judgment when selecting sample sizes, the GAS/A-133 AICPA Audit Guide emphasizes in Paragraph 10.33 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.” In addition, although the GAS/A-133 AICPA Audit Guide does not provide specific guidance on sample size, Paragraph 10.41 states that:

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.

The GAS/A-133 AICPA Audit Guide, Paragraph 10.41, further explains that sample size is affected by the planned level of detection risk, tolerable misstatement, expected misstatement, and the nature of the population. However, other matters should be considered, including whether different selective means of testing may be more effective, such as selecting large or unusual items from a population instead of selecting a sample or stratifying the population for sampling purposes.

Concerns about Sample Size. As federal awarding agencies and their offices of the Inspector General (IG) have reviewed audits performed under OMB Circular A-133, the size of audit samples for tests of compliance have been a frequent cause for concern. In some cases, IGs have concluded that the small size of the sample selected and tested may not have been sufficient to support an opinion on compliance. This concern was reiterated in other meetings attended by representatives of federal agencies, federal IGs, program personnel, the AICPA, GAO, OMB, state auditors, and practitioners. Auditors should be aware of such concerns and any audit alerts or other reports issued by IGs, other federal agency representatives or the AICPA that provide guidance or comments concerning audit sampling.

Factors That Affect Sample Size. OMB Circular A-133 at Section 525 states that the selection of testing of transactions should be based on the auditor's professional judgment considering such risk factors as the following:

- *Size of Program.* The larger or smaller the amount, the greater or lower the risk.
- *Program Maturity at the Federal Agency.* The newer the program, the greater the risk. Also, significant changes in the law, regulations, or the provisions of contracts or grants agreements may increase risk.
- *Program Maturity at the Auditee.* The risk may be higher in the first and last year of a program due to the peculiarities related to start-up or close-out of program activities and staff.
- *Complexity.* The more complex the program (eligibility, calculations, etc.), the greater the risk. The simpler the program, the less the risk.
- *Extent of Contracting.* The greater the amount of program contracting for goods and services, the greater the risk.
- *Multiple Internal Control Structures.* Programs administered by multiple internal control structures, for example when multiple locations or branches are involved, may have a higher risk. [Sec. 525(b)(1)(i)]
- *Use of Subrecipients.* When significant parts of a federal program are passed through to subrecipients, a weak system for monitoring subrecipients would indicate higher risk.
- *Extent of Computer Processing.* Significant use of computer processing (for transmitting, processing, maintaining, or accessing information related to federal awards) may indicate higher risk. Also, computer

systems used to administer federal awards may indicate higher risk if they are complex, new (and not previously tested), or recently modified. [Sec. 525(b)(1)(iii)]

- *Level of Oversight.* The greater the level to which the program is subject to review or other forms of independent oversight, the lower the risk. Recent oversight which disclosed no significant problems would boost the low-risk assessment. Recent oversight which disclosed significant problems would indicate higher risk.
- *Prior Audit Findings.* Prior audit findings relative to the program may indicate a higher risk, particularly when the situation identified in the audit findings could have a significant impact on the program or have not been corrected.

These factors also affect the level of inherent risk that violation of laws and regulations could have a material effect on major federal award programs. In assessing inherent risk, the auditor should also consider the results of other procedures performed as part of the audit of the financial statements.

Requirements for “Adequate” or “Representative” Number

The previous OMB audit circulars (A-128 and A-133) included requirements to select and test for compliance using an *adequate or representative* number of transactions from each major program. The 1997 OMB Circular A-133 does not mention a sample or use the terms “adequate” or “representative” in connection with its discussion of testing compliance. However, the *OMB Circular A-133 Compliance Supplement* (Compliance Supplement) uses the phrase “select a sample.” In addition, Paragraph 10.41 of the GAS/A-133 AICPA Audit Guide notes that auditors generally use sampling to obtain audit evidence. The GAS/A-133 AICPA Audit Guide also refers auditors to the AICPA Audit Guide, *Audit Sampling* for help in applying audit sampling in accordance with SAS No. 39. SAS No. 39, as amended (AU 350.24) states that a sample should be a “representative sample” (that is, the sample items should be selected in such a manner that all items have an opportunity to be selected). The auditor should select a representative number of transactions from each major program, but is not required to select separate samples from each major program.

Selecting the Sample

Sample selection will generally be made from each major program’s transactions. However, there is no requirement to use a separate sample for each major program (even though the auditor is required to obtain sufficient appropriate audit evidence to support an opinion on compliance for each major program). Paragraph 10.44 of the GAS/A-133 AICPA Audit Guide explains 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 audit samples are selected from transactions for all major programs, the audit documentation should clearly indicate that the results of such samples, together with other audit evidence, are sufficient to support the opinion on each major program’s compliance.

Evaluating the Sample Results

SAS No. 39 (AU 350.26) states, “The auditor should project the misstatement results of the sample to the items from which the sample was selected. . . .” As discussed in Paragraph 10.42 of the GAS/A-133 AICPA Audit Guide, OMB Circular A-133 and SAS No. 74 state that the auditor should determine the amount of likely questioned costs associated with audit findings. These requirements maybe met by projecting the amount of questioned costs found in the sample when performing sampling for tests of compliance. In evaluating the sampling results in an OMB Circular A-133 audit, the auditor compares total projected questioned costs for each major federal award program or award to the amount of questioned costs considered material for that program and considers the risk that such result might be obtained even though the amount of questioned costs exceeds the amount considered material (i.e., sampling risk).

If the auditor determines that the projected amount of questioned costs are material to the individual program or that sampling risk is unacceptable, the auditor’s report should be modified [SAS No. 74 (AU 801.17–.20)]. The auditor’s estimate of projected costs is also necessary to determine whether a finding must be reported in the schedule of findings and questioned costs. Even though the auditor is required to project the questioned costs

identified from the items sampled to the population as a whole, only the actual (known) questioned costs resulting from the items tested need to be reported in the schedule of findings and questioned costs. Also, the scope of the audit is not required to be expanded. However, the auditor should consider the potential effect of the questioned costs in reporting on the entity's financial statements and on compliance of the individual financial award programs.

Circumstances Indicating a Need for Statistical Sampling

In certain circumstances, the auditor will not be able to follow the guidance recommended in the following section on sample size. These circumstances are as follows:

- *Specific Program Requirements.* Some specific federal award programs may require the use of statistical sampling; e.g., for a program-specific audit, a funding agency's audit guide may require statistical rather than nonstatistical sampling and suggest minimum sample sizes.
- *Large Amount of Compliance Exceptions.* The approach is appropriate when a relatively small amount of compliance exceptions is expected. When the auditor expects to find many deficiencies, it is generally advisable to use statistical sampling with relatively large sample sizes to estimate the upper limit on the rate or monetary amount involved.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

32. Which of the following risk factors generally indicates a lower risk?
- a. Prior-audit findings.
 - b. Subrecipient use.
 - c. Increased complexity.
 - d. Greater oversight level.
33. The purpose of compliance test is to decide if any noncompliance exists that could have a material effect on the financial statement. This test also provides a basis for providing an opinion on major programs. Thus, tests of compliance are usually considered _____ because they are achieved by examining supporting documentation.
- a. Triple purpose tests.
 - b. Judgment tests.
 - c. Substantive tests.
34. Which of the following situations would prevent an auditor from using sampling?
- a. Eligibility for programs.
 - b. Procurement of a single parcel of raw land during the year.
 - c. Procurement procedures of the program.
35. Which of the following statements regarding the evaluation of sample results is **least** accurate?
- a. When evaluating sample results, the auditor's estimate of projected cost is necessary.
 - b. When evaluating sampling results in an OMB Circular A-133 audit, the auditor should compare the actual rate of deviations to tolerable rate of deviations.
 - c. When projecting costs in a sample evaluation, the auditor is only required to report the known questions that result from the items tested.
 - d. The auditor is not required to expand the scope of the audit when evaluating sample results.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

32. Which of the following risk factors generally indicates a lower risk? **(Page 228)**

- a. Prior-audit findings. [This answer is incorrect. Prior-audit findings that are relative to the program are usually indicators of a higher risk.]
- b. Subrecipient use. [This answer is incorrect. Monitoring subrecipients under a weak system usually indicates an increased risk when significant parts of the federal program are passed through to subrecipients.]
- c. Increased complexity. [This answer is incorrect. The level of risk increases with increase of complexity.]
- d. **Greater oversight level.** [This answer is correct. Generally, if a program is subject to review or other forms of independent oversight at an increased level, the lower the risk. Low-risk assessment is increased when recent oversight is disclosed with minimally significant issues.]

33. The purpose of compliance test is to decide if any noncompliance exists that could have a material effect on the financial statement. This test also provides a basis for providing an opinion on major programs. Thus, tests of compliance are usually considered _____ because they are achieved by examining supporting documentation. **(Page 227)**

- a. Triple purpose tests. [This answer is incorrect. The triple-purpose test involves choosing a sample of transactions and inspecting the supporting documentation to determine indications of compliance; performance of tests of controls; and incorrectly recorded amounts, periods and accounts.]
- b. Judgment tests. [This answer is incorrect. An auditor's judgment should not be solely used in making this determination since the type of test implemented is achieved by examining supporting documentation.]
- c. **Substantive tests.** [This answer is correct. Tests of compliance are considered substantive tests. In a single audit, substantive test of transactions usually relate to major program compliance with contract, laws, grant agreements, and regulations.]

34. Which of the following situations would prevent an auditor from using sampling? **(Page 227)**

- a. Eligibility for programs. [This answer is incorrect. Eligibility is a compliance requirement that includes sampling.]
- b. **Procurement of a single parcel of raw land during the year.** [This answer is correct. Sampling is not appropriate when the sampling is not large enough. This is an example of evidence that does not lend itself to sampling.]
- c. Procurement procedures of the program. [This answer is incorrect. This is a compliance requirement that includes sampling.]

35. Which of the following statements regarding the evaluation of sample results is **least** accurate? (Page 229)
- a. When evaluating sample results, the auditor's estimate of projected cost is necessary. [This answer is incorrect. An auditor will use his or her estimated projected costs to determine if a finding should be reported in the schedule of findings and questioned costs.]
 - b. When evaluating sampling results in an OMB Circular A-133 audit, the auditor should compare the actual rate of deviations to tolerable rate of deviations. [This answer is correct. This statement is not accurate because the auditor should compare the total projected questioned costs for each major federal award program to the amount of questioned costs considered material for the program. The auditor should also consider the risk that such result may be obtained even though the amount of questioned costs exceeds the amount that is considered material.]**
 - c. When projecting costs in a sample evaluation, the auditor is only required to report the known questions that result from the items tested. [This answer is incorrect. Although the auditor is required to project the questioned costs identified from the items sampled to the entire populations, the auditor is only required to questions the actual or known questioned costs that result from the items tested.]
 - d. The auditor is not required to expand the scope of the audit when evaluating sample results. [This answer is incorrect. Although the auditor has to consider the possible effect of the questioned costs in reporting on the entity's financial statements, he or she is not required to expand the scope of the audit.]

PLANNING THE EXTENT OF SUBSTANTIVE TESTS OF COMPLIANCE

When testing compliance in a single audit, the auditor is concerned with *both* the rate of noncompliance in the population being tested as well as the dollar value of noncompliance. Therefore, the auditor must develop an approach to testing compliance that addresses both of these concerns. This section provides the auditor with an effective and efficient approach to testing compliance.

Planning the Extent of Substantive Procedures

The Compliance Supplement requires, for certain of its suggested audit procedures, that the auditor “select a sample.” However, minimum “sample” sizes and acceptable selection methods are not specified. The Compliance Supplement permits these matters to be determined based on the auditor’s professional judgment. It is believed that a “sample” as used here does not necessarily mean use of sampling. In many instances because of other procedures performed, low inherent and control risk, and/or small population sizes, sampling may not be necessary.

As a general rule, sampling may not be efficient when the population is less than 100. In these instances, reviewing individually significant and unusual items, if any, and the internal control system will often be sufficient. If the test at first appears to be insufficient, it may be acceptable to simply lower the cutoff for individual significant items resulting in a larger amount of individually significant amounts.

A low combined inherent and control risk and other audit procedures should result in a lower level of test work. Other audit procedures might include analytical review, inquiry, and observations, as well as other procedures. This applies either in the situation referred to in the preceding paragraph or when sampling is being performed.

In instances where the “sample” is being taken from a very small population number, the auditor should, after considering the combined inherent and control risk, review all or selected items based on his or her judgment. For example, if the combined inherent and control risk is low, the auditor might select one interim and the final (year-end) Financial Status Report. If the risk is moderate or high, the auditor might select all or any number of the monthly reports based on his or her professional judgment.

It is believed that, as a matter of “sample” design and selection, the transactions of each major program do not have to be treated as separate populations; however, the “sample” size, in the context of this discussion, for a particular major program should be equivalent to the “sample” size that would have been considered appropriate had the transactions charged to that program been viewed as a separate population. It is also believed that it may be simpler in many instances to select a “sample” for each major program.

The following type of question is often asked. A program for an audit period has 500 disbursements and only 70 involve Davis-Bacon Act requirements. An overall sample of disbursements selected randomly included 5 of the disbursements involving Davis-Bacon. Is the “sample” of 5 sufficient for testing Davis-Bacon or should an additional sample be selected? This is a matter of professional judgment. One approach would be to draw a conclusion based on whether a sample of 5 would be a sufficient sample for a population of 70. However, it should be noted that an opinion is being expressed on the program and not on each of the fourteen types of compliance requirements individually and therefore it may not be necessary to select a “sample” from the 70 disbursements. If only 10 transactions involve Davis-Bacon, and the total is not material to the program, it may not be necessary to test any of the 10. In addition, the auditor is only required to test compliance requirements if (a) they are applicable to a particular program *and* (b) the auditor believes that noncompliance with the requirement could have a material effect on the major program.

The President’s Council on Integrity and Efficiency Standards Subcommittee indicated in its report, *Study on Improving the Single Audit Process*, that “a sample size of 25 items . . . would only be acceptable when internal control risk is determined to be low and prior audits have found very little noncompliance.” While the PCIE study is nonauthoritative, this statement indicates that a sample size of 25 for testing compliance with laws and regulations is the minimum which federal agencies would consider acceptable. While this study was released prior to the new OMB Circular A-133. There is no reason at this time to believe the PCIE will look at the matter any differently in relation to the new Circular.

The size of the sample selected may be reduced by the number of transactions charged to the major program that were included in a sample tested in conjunction with other audit procedures. For example, if a sample tested for other audit purposes (e.g., tests of internal controls or tests of details performed for the audit of the financial statements) included five transactions from the major program, then the auditor may reduce the sample size for compliance purposes by those five items. (However, the auditor should be sure that all the applicable compliance requirements were tested for those five items.)

Interim Audit Procedures. When auditors perform audit procedures to test compliance at year end, the selection of a sample is made in such a manner as to be representative of the transactions for the period under audit. If the auditor decides to perform audit procedures at an interim date, the auditor should perform procedures at year end to update the audit findings and to ensure that the interim testing provides sufficient appropriate audit evidence to support the opinion on compliance applicable to each major federal award program.

Practical Approach to Testing Compliance

Because of the increased cost that may be associated with sampling, it is important for the auditor to consider the effectiveness of alternative approaches before concluding that sampling is necessary. Exhibit 2-4 outlines the steps for a practical approach to planning the extent of substantive procedures for a single audit.

Exhibit 2-4

Steps for a Practical Approach to Planning the Extent of Substantive Procedures for a Single Audit

<u>Step Description</u>	<u>Result</u>
1. Assess the appropriate level of tolerable noncompliance.	Tolerable noncompliance (5% of total expenditures for each major program).
2. Determine an amount for individually significant dollar items.	Any amount less than tolerable noncompliance may be used. (One-third of tolerable noncompliance is often used.)
3. Identify unusual items.	Identification of additional items to be tested 100%.
4. Calculate remaining balance after selecting individually significant items (Steps 2. and 3.).	Calculated amount.
5. Determine what procedures, if any, are needed to test the remaining balance.	Procedures, if any, needed to test remaining balance.

* * *

Step 1—Assess the Level of Tolerable Noncompliance. Generally, tolerable noncompliance is determined to be 5% of total expenditures for each major program.

Step 2—Determine an Amount for Individually Significant Items. The term *individually significant items* encompasses two types of items:

- a. Individually significant dollar items.
- b. Unusual items (that is, items that have audit significance by their nature).

In determining the extent of substantive procedures, the auditor should first select an amount for individually significant dollar items and then consider any unusual items.

Generally, when performing tests of details, the auditor should at least examine all items that equal or exceed tolerable noncompliance. Accordingly, the cutoff amount for determining individually significant dollar items cannot

exceed tolerable noncompliance. As a rule of thumb, auditors often use one-third of tolerable noncompliance as the cutoff for individually significant dollar items. However, the auditor may choose any amount less than tolerable noncompliance in order to reduce the risk of material noncompliance of the remaining balance to an acceptable level.

Consider, for example, that XYZ Organization has total major federal program expenditures of \$670,000. Tolerable noncompliance would be \$33,500 ($\$670,000 \times 5\%$). Suppose the organization has program expenditures composed of the following transaction groups:

Number of Transactions	Range of Amounts	Total Amount
4	\$75,000–\$150,000	\$ 480,000
3	\$13,000–\$74,999	91,000
<u>436</u>	Less than \$13,000	<u>99,000</u>
<u>443</u>		<u>\$ 670,000</u>

Using the rule of thumb for individually significant dollar items, the auditor would select every item over one-third of tolerable noncompliance (approximately \$11,000). In this example, that would include all the items in the top two categories plus perhaps part of the bottom category. However, depending on the circumstances and the auditor's judgment about the remaining balance, the auditor may decide to initially select only the items in the top two categories. In this case study, the auditor would probably define individually significant dollar items as items comprising the top two categories only. This approach is appropriate because the cutoff amount of \$13,000 is less than tolerable noncompliance. This approach is also efficient because the auditor can test only seven items and obtain coverage of over 85% of the total program expenditures $[(\$480,000 + \$91,000) \div \$670,000]$.

Step 3—Identify Unusual Items. An item also may be individually significant if, because of its nature, it is prone to noncompliance. These are referred to these items as “unusual items.” It is important for auditors to look for unusual items whenever a substantive test of compliance is performed. Unusual items may be identified based on the following:

- Prior experience.
- Results of analytical procedures.
- Other unusual characteristics.

Prior Experience. Based on historical experience with a client, an auditor may be aware of types of items that are highly susceptible to noncompliance. The audit may need to be structured to select such items that have historically been a problem and subject these items to individual examination. This approach can add efficiency by going directly to the problem.

Results of Analytical Procedures. The nature of many specific requirements related to federal program expenditures are such that the auditor often obtains only minimal assurance from analytical review procedures. However, the auditor may be able to use analytical procedures to identify individually significant items or to otherwise identify populations that need to be sampled. Analytical review procedures can be useful in assessing the reasonableness of the schedule of expenditures of federal awards.

Unusual Characteristics. This category is by nature difficult to define because it includes virtually any characteristic that the auditor identifies as worth investigating; e.g., related party transactions or balances, unusual or unfamiliar vendor names, etc. The auditor may also regard a category of items as unusual because of concern with compliance with specific laws and regulations and provisions of contracts and grant agreements.

Step 4—Calculate the Remaining Balance. After the individually significant items have been selected, the remaining balance should be computed. The remaining balance is calculated by subtracting the individually significant and unusual items from the total population being tested.

Comparing the Remaining Balance to Tolerable Noncompliance. After computing the remaining balance, the auditor should compare it to tolerable noncompliance. Normally, the auditor will not need to apply additional audit procedures to the remaining balance if it is less than tolerable noncompliance. However, the decision of whether to apply additional audit procedures to the remaining balance is a matter of professional judgment.

Step 5—Consider Need to Apply Additional Procedures to the Remaining Balance. If the remaining balance exceeds tolerable noncompliance, the auditor considers what procedures, if any, are needed to obtain sufficient audit evidence concerning that balance. Generally, the following options should be considered:

- a. Determining that no additional audit procedures are needed.
- b. Performing analytical procedures.
- c. Applying audit sampling.
- d. Expanding the audit procedures performed on individually significant items.

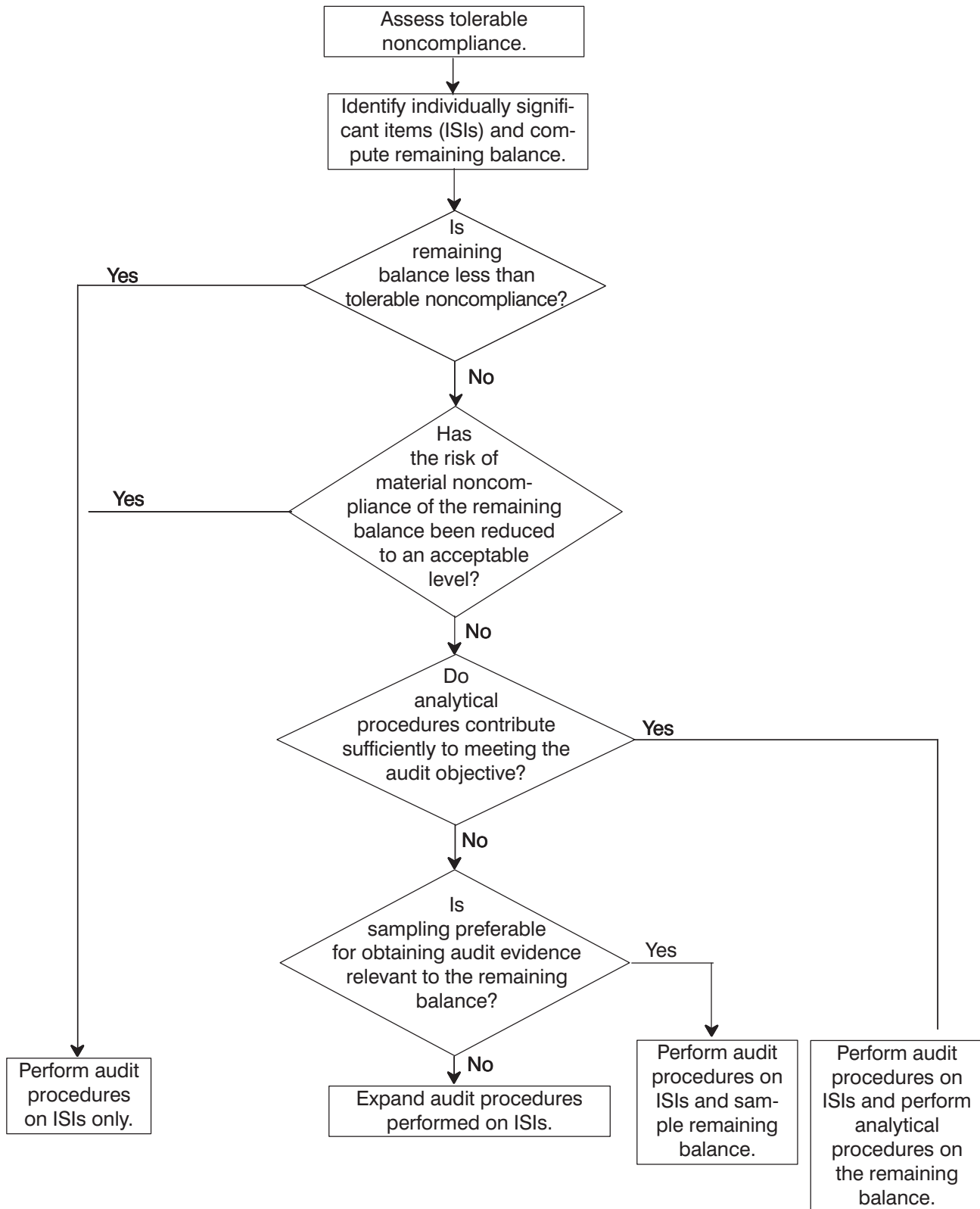
Exhibit 2-5 illustrates the thought process involved in considering these options. Each option is discussed separately in the following paragraphs. However, the auditor may use a combination of these options with respect to the remaining balance.

Determining That No Additional Audit Procedures Are Needed. The auditor may decide to perform no further audit procedures on the remaining balance after considering the risk of material noncompliance of the remaining balance. In assessing the risk of material noncompliance of the remaining balance, the auditor should consider the following factors:

- a. *Characteristics of the Remaining Balance.* The auditor may have some knowledge of the program from prior experience and other audit procedures performed, including audit procedures performed on individually significant items and tests of controls. Using that knowledge, the auditor should consider the nature, size, and frequency of noncompliance necessary for the remaining balance of program expenditures to be materially noncompliant. For example, if the auditor determines that the remaining balance is composed of many small dollar items and believes there is a low rate of noncompliance in the remaining balance, then it may be possible to assess the risk of material noncompliance of the remaining balance as low.
- b. *Risk of Material Noncompliance of the Program.* The risk of material noncompliance of the remaining balance is related to the risk of material noncompliance of the entire program. Those risks, however, would not necessarily be the same because (1) the remaining balance is smaller and (2) the auditor may be able to separately identify items that are prone to noncompliance and perform audit procedures on them individually. Accordingly, the risk of material noncompliance of the remaining balance may be lower than the risk for the program.

As is the case at the program level, the higher the risk of material noncompliance of the remaining balance, the greater the assurance that is needed from substantive procedures. Accordingly, the auditor generally will need to perform additional audit procedures on the remaining balance the risk of material noncompliance of the remaining balance is low. Furthermore, even if those criteria are met, it is generally advisable for the auditor to at least scan the remaining balance for unusual items, which are discussed in Step 3.

Exhibit 2-5
Determining the Extent of Substantive Procedures



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Performing Analytical Procedures. In evaluating whether analytical procedures provide adequate evidence for the remaining balance, the auditor should consider the risk of material noncompliance of the remaining balance and the effectiveness of those analytical procedures, especially since the nature of many specific compliance requirements is such that often only minimal assurance can be obtained from analytical review procedures.

Applying Audit Sampling. If the auditor decides that analytical procedures do not provide sufficient appropriate audit evidence with respect to the remaining balance, then tests of details must be applied to the remaining balance. Consequently, the auditor has two remaining options—using audit sampling or expanding the audit procedures performed on individually significant items. In deciding between those options, the auditor should consider the following factors:

- a. *Number of Items in the Remaining Balance.* If the remaining balance consists of numerous items (such as 200 items or more), sampling generally is more efficient. However, if the auditor can further reduce the amount of the remaining balance by performing audit procedures on only a few of the larger items in the remaining balance, then it is probably more efficient to perform audit procedures on those larger items instead of sampling.
- b. *Expected Noncompliance in the Remaining Balance.* Generally, if the expected noncompliance in the remaining balance exceeds one-third of tolerable noncompliance, sampling risk would be too high and sampling would not be appropriate. However, it may be possible to isolate the items that are most prone to noncompliance, perform audit procedures on 100% of those items, and sample the remaining population.

Assuming that sampling risk is at an acceptable level, the consideration is a matter of efficiency (that is, which option results in applying audit procedures to the fewest items). For large populations of small dollar items, sampling generally is more efficient.

Expanding the Audit Procedures Performed on Individually Significant Items. As discussed in the preceding paragraph, the auditor should consider this option only after determining that—

- a. Tests of details are needed to obtain sufficient appropriate audit evidence concerning the remaining balance, and
- b. This option is preferable to sampling the remaining balance.

Expanding the audit procedures performed on individually significant items normally is accomplished by—

- a. Lowering the amount for individually significant dollar items.
- b. Choosing additional unusual items if needed.

After expanding audit procedures on individually significant items, the auditor should determine whether sufficient appropriate evidence has been obtained to eliminate the need to sample the remaining balance.

The Importance of Identifying Individually Significant Items

In planning, an auditor should always consider the audit evidence obtained by applying substantive procedures to individually significant items or transactions. Since SAS No. 39, as amended, establishes certain requirements and demands on the auditor when sampling is used, it is imperative that the auditor challenge the need to perform any sampling. The question is whether the audit procedures performed on individually selected items alone, or combined with analytical procedures and the results of audit procedures performed on controls, provide sufficient appropriate audit evidence. Even when the auditor decides that sampling is necessary, efficiency will usually be improved considerably by dividing the program expenditure balance between individually significant items and items to be sampled.

Nonstatistical Sampling for Tests of Compliance of Remaining Balance

If after performing the procedures described earlier in this lesson, the auditor concludes that they do not provide sufficient audit evidence with respect to the remaining balance and that audit sampling is appropriate, then the

approach described at the paragraphs below should be followed in applying audit procedures to the remaining balance.

Table 4-4 of the AICPA Sampling Guide summarizes the effects of changes in various factors, such as tolerable noncompliance and inherent and control risk, on sample sizes for substantive tests of details. Table 4-4 illustrates the relative effect of the factors (that is, smaller or larger) on sample size rather than providing specific numerical sample sizes. Table 4-5 of the AICPA Sampling Guide illustrates specific numerical sample sizes that might be used for statistical or nonstatistical sampling based on the Monetary Unit Sampling (MUS) statistical approach [sometimes called the Probability Proportional to Size (PPS) approach].

Nonstatistical Sampling Approach to Substantive Tests of Compliance

This approach to performing substantive tests of compliance is adapted from the AICPA Sampling Guide and is based on the statistical theory of Monetary Unit Sampling (MUS) [also called Probability Proportional to Size (PPS) sampling]. It is recommended the use of this model as a practical method of determining sample size for nonstatistical sampling. The use of this model is recommended as a practical method of determining sample size for nonstatistical sampling. Exhibit 2-6 outlines the steps to applying this sampling method.

Exhibit 2-6

Steps for a Nonstatistical Sampling Approach to Substantive Tests of Compliance

<u>Step Description</u>	<u>Required Result</u>
1. Assess appropriate level of tolerable noncompliance.	Tolerable noncompliance amount (normally calculated as 5% of total program expenditures).
2. Assess the risk of material noncompliance.	One of three qualitative levels of risk—high, moderate, or low—based on the assessments of inherent and control risk.
3. Use the table in Exhibit 2-8 to determine a risk factor.	A factor between 1.9 and 3.0.
4. Estimate population balance after removal of items to be examined 100% (individually significant items).	Quantified amount.
5. Consider the amount of expected likely noncompliance in the population to be sampled.	If expected noncompliance exceeds $\frac{1}{3}$ of tolerable noncompliance, sampling normally should not be used.
6. Estimate the sample size using the following formula:	
$\frac{\text{Dollar value of remaining population (Step 4.)}}{\text{Tolerable noncompliance (Step 1.)}} \times \text{Risk factor (Steps 2. and 3.)}$	Sample size.
7. Adjust sample size for lack of stratification in the sample, if applicable.	Possible sample size increase.
8. Adjust sample size for items previously tested.	Possible sample size decrease.

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Step 1—Assess Tolerable Noncompliance. The amount that should be used for tolerable noncompliance (questioned costs) is the amount calculated in the “Planning Materiality—Federal Award Programs”—normally 5% of total expenditures for the program.

Step 2—Assess the Risk of Material Noncompliance. The risk of material noncompliance (questioned costs) is the combination of inherent risk and control risk. Exhibit 2-7 shows how the assessments of inherent risk and control risk may be combined to determine the risk of material noncompliance (questioned costs).

Exhibit 2-7

Combined Risk of Material Noncompliance

Inherent Risk Assessment	Control Risk Assessment		
	High	Moderate	Low
High	High	High	Moderate
Moderate	Moderate	Low	Low
Low	Low	Low	Low

* * *

Theoretically, the auditor should assess the risk of material noncompliance of the population to be sampled (that is, the balance of program expenditures excluding individually significant items). However, in sampling applications, the risk of material noncompliance for the program normally is a reasonable approximation of the risk of material noncompliance of the remaining balance. Because the risk of material noncompliance in the remaining balance is almost always equal to or less than the risk for the entire program, using the risk of material noncompliance for the entire program is both reasonable and conservative.

Step 3—Identify a Risk Factor. Using the table presented in Exhibit 2-8, identify a risk factor based upon the auditor's assessment of the program's combined risk of material noncompliance. The factors in the table correspond to levels for the risk of incorrect acceptance:

Exhibit 2-8

Table for Determination of Risk Factor

Risk of Material Noncompliance	Risk Factor
High	3.0
Moderate	2.3
Low	1.9

* * *

Step 4—Estimate Remaining Population. The next step is to determine the dollar amount of items to be sampled by reducing the total amount of the balance or transaction class (i.e., total major program expenditures) by individually significant items. As explained earlier, an item may be individually significant because of its nature or size. Generally, the most efficient approach is to identify individually significant dollar items as all items greater than or equal to tolerable noncompliance divided by the applicable risk factor as determined in Step 3. That is, the fewest total number of items will be tested when individually significant dollar items are defined as tolerable noncompliance divided by the applicable risk factor. Often, however, the efficiency gained between using one-third, one-half, or some other fraction of tolerable noncompliance is minimal. Consequently, it is recommended that individually significant dollar items be defined as all items greater than or equal to one-third of tolerable noncompliance. However, the cutoff amount for individually significant dollar items can be any amount up to tolerable noncompliance. The choice of a cutoff amount is a matter of efficiency.

Step 5—Consider Expected Noncompliance. The last step before determining the sample size is to consider the amount of expected likely noncompliance in the population to be sampled based on the auditor's knowledge of the population and prior experience. If the amount of likely (i.e., projected) noncompliance is expected to exceed one-third of tolerable noncompliance, sampling normally is not appropriate.

Step 6—Estimate Sample Size. To calculate the sample size, divide the total of the population to be sampled (account balance or transaction class less individually significant items) by tolerable noncompliance, and multiply that result by the risk factor determined in Step 3.

Step 7—Increase Sample Size for Lack of Stratification. This sampling approach depends on dividing the items being tested into at least three groups: individually significant items and an upper and lower group of remaining items. If the auditor finds it impractical to stratify after identifying individually significant items, the sample size calculated in Step 6. must be increased. The AICPA Sampling Guide at Paragraph 4.32 notes that auditors typically increase the sample size from 10% to 50% if the sample is not stratified but notes that an adjustment of 100% or more may be needed when there is extreme variability in the characteristic of audit interest. It is noted that firms with nonstatistical sampling plans advocate different percentage increases ranging from 10% to 100%. It is recommended that sample size be increased approximately 20% if stratification is not practical and there is not a significant variation in the items being sampled.

Step 8—Adjust Sample Size for Items Tested. The sample size calculated in either Step 6. or Step 7. should be reduced for the items selected, and tested for compliance, as part of the financial statement audit and for those items selected for tests of controls that were also tested for compliance in a dual- or triple-purpose test.

An Example Using the Approach. The City of Citrus Grove has a Department of Transportation (DOT) Airport Improvement Program that has been identified as a major program. The program has total expenditures of \$306,000. The composition of the expenditure balance at the balance sheet date is as follows:

Number of Transactions	Range of Amounts	Total Amount
2	\$5,100 and over	\$ 86,000
<u>3,998</u>	Below \$5,100	<u>220,000</u>
<u>4,000</u>		<u>\$ 306,000</u>

The auditor has assessed control risk. While testing controls and other substantive procedures applied to the financial statements, the auditor selected eight transactions from the DOT Airport Improvement Programs for testing. The steps in Exhibit 2-9 describe the auditor's considerations in applying the recommended approach to substantive tests of compliance for the major program.

Exhibit 2-9**Steps to Applying Recommended Approach to Substantive Tests of Compliance**

Step Description	Required Result
1. Assess tolerable noncompliance.	Calculated as 5% of total program expenditures—\$15,300.
2. Assess the risk levels.	Moderate ^a
3. Identify a risk factor.	The table indicates a risk factor of 2.3.
4. Estimate remaining population.	The remaining balance is \$220,000; i.e., the balance remaining after all individually significant items are identified. An individually significant item is determined to be any expenditure over one-third of tolerable noncompliance, or \$5,100. The total of individually significant items is \$86,000, and the population to be sampled is $\$306,000 - \$86,000 = \$220,000.$
5. Consider expected noncompliance.	Based on prior experience with the client, expected noncompliance is \$2,500 (approximately 16% of tolerable noncompliance). Thus, sampling is considered appropriate.
6. Estimate sample size.	The auditor calculates sample size as follows: $\frac{\$220,000}{\$15,300} \times 2.3 = 34 \text{ (rounded up)}$
7. Increase for no stratification.	The auditor decides it is impractical to stratify balances below \$5,100 and increases sample size by 7 (approximately 20%) for a total sample size of 41.
8. Adjust sample size for items previously tested.	The auditor has already tested the eight transactions selected during internal control and other substantive testing for compliance with laws and regulations. As a result, the auditor will only need to select an additional sample of 33 (41 – 8) transactions.

Note:

- ^a The auditor is reminded that while OMB Circular A-133 requires tests of controls to support a low assessed level of control risk, there is no requirement to achieve low level. In this example, it is assumed that based on the internal controls (and the tests of those controls) and the inherent risk, the risk of material noncompliance is assessed as moderate.

* * *

In this example, the auditor has concluded that sampling is necessary. Initially, sampling is indicated because the remaining balance is over 14 times the tolerable noncompliance and, thus, audit procedures will need to be applied to the remaining balance.

Using Data Extraction Software to Select the Sample. Some auditors may use data extraction software in audit sampling. The ability of data extraction software to quickly process large volumes of data can save time spent on sample selection.

Projecting the Noncompliance

Project the amount of noncompliance (questioned costs) found in the sample to the items from which the sample was selected. The auditor may use one of several methods to satisfy the requirement of SAS No. 39 to project the

sample questioned costs to the population. One such method presented in the AICPA Sampling Guide is described below.

Ratio Method. The ratio of sample dollars (the total of all items selected) to population dollars (the total of the population from which the sample was selected) is used to project the sample questioned costs as follows:

$$\frac{\text{Amount of sample questioned costs}}{\text{Sample dollars}} \times \text{Population dollars} = \text{Projected population questioned costs}$$

Thus, if an auditor has identified \$500 of sample questioned costs, sample dollars are \$60,000, and the population dollars are \$600,000, the projected questioned costs would be calculated as:

$$\frac{\$500}{\$60,000} \times \$600,000 = \$5,000 \text{ (projected population questioned costs)}$$

If the population is stratified, the misstatement should be projected by stratum and added together. Noncompliance noted for items checked 100% should also be added in to arrive at the total.

Considering Sampling Risk

In a statistical sample, sampling risk can be measured based on sample results. In a nonstatistical sample, precise measurement is not possible. However, using the sampling model discussed in this section, the auditor may consider sampling risk through answering the following questions:

- a. Does projected noncompliance exceed expected noncompliance? If yes,
- b. Does projected noncompliance exceed one-third of tolerable noncompliance?

The results of those answers can be used to assess sampling risk as follows:

- a. If the answer to these questions is "no," the auditor usually need not be concerned about unacceptable sampling risk under this sampling model.
- b. If the answer to both questions is "yes," the auditor would normally assume there is an unacceptable risk that the true noncompliance exceeds tolerable noncompliance. The auditor is not required to expand the scope of his or her audit or to include a projection of questioned costs in the schedule of findings and questioned costs; however, the potential effect of the questioned costs must be considered not only on the entity's financial statements but also on compliance of the individual federal award program.

Unacceptable Sampling Risk. The auditor should take appropriate actions if the sample results indicate that planning assumptions were incorrect. For example, if the auditor discovers noncompliance in amounts or frequency that exceed those considered in the assessed levels of inherent and control risk, the auditor's risk assessments should be altered. The auditor should also consider whether to modify other audit tests that were based on the inherent and control risk assessments.

The general approach to dealing with unacceptable sampling risk is to isolate the nature and cause of the noncompliance found in the sample. The auditor should then look for additional noncompliance in the population that may have arisen from that same cause. Once those instances of noncompliance are identified, the auditor can determine the projected questioned costs. However, if the nature and cause of the instances of noncompliance in the sample cannot be isolated (if there is no detectable pattern to them), the auditor should consider performing additional substantive procedures or expanding the sample.

Evaluating Sample Results

The auditor's evaluation of the sample should be considered along with other relevant audit evidence when forming a conclusion about program compliance, an account balance, or class of transactions. SAS No. 39, as amended,

(AU 350.25) requires the auditor to apply audit procedures that are appropriate to the particular audit objective to each item in a sample. When supporting documentation cannot be located for selected items, the auditor cannot apply the planned audit procedures. In this situation, the treatment of unexamined items will depend on their effect on the auditor's evaluation of the sample results.

When testing compliance in a single audit, the auditor is concerned not only with the dollar amount of noncompliance but also the rate of noncompliance in the population. Therefore, the auditor should consider not only the dollar amount of questioned costs but also the number of items of noncompliance identified. Even though the dollar value of questioned costs may be insignificant, if it results from numerous instances of small dollar items of noncompliance, the auditor should consider the overall effect on determining whether the program is or is not in compliance. The qualitative aspect of the instances of noncompliance should also be considered. For example, the auditor should consider how the inability to examine items affects the assessment of the risks of material misstatement due to fraud, the assessed level of control risk that the auditor expects to be supported, or the degree of reliance on management representations.

Considering Qualitative Characteristics

Size and frequency of noncompliance in a sampling application are not the only factors that should be considered. An auditor should, according to SAS No. 39 (AU 350.27), as amended by SAS No. 111, consider the following qualitative aspects of the noncompliance (questioned costs):

- a. The nature and cause of any questioned costs:
 - (1) Do the questioned costs result from an error (unintentional) or is it from a possible fraud (intentional)?
 - (2) If the noncompliance is the result of an error, is it due to misunderstanding of instructions or carelessness?
- b. The possible relationship of questioned costs to other phases of the audit.

Documenting the Substantive Sampling Application

Although SAS No. 39, as amended, does not impose specific documentation requirements for audit sampling, SAS No. 103 (AU 339.04) requires that audit documentation be sufficient to document that the applicable field work standards have been observed. In other words, the audit documentation should show that SAS No. 39 has been complied with. The lack of documentation of sampling is one of the most common topics in letters of comments for peer reviews and findings in quality control reviews. Both AICPA standards and the Yellow Book state that the audit documentation should be sufficient to enable an experienced auditor with no connection with the audit to understand the nature, timing, extent, and results of the audit procedures performed. In addition, SAS No. 103, states that documentation of audit procedures, including those involving sampling, should include identifying characteristics of the specific items that were tested. This requirement specifically includes tests of the operating effectiveness of controls and substantive tests of details involving inspection of documents. Thus, the audit documentation should document all important aspects of the engagement, including the sampling and other selection criteria used, and should be sufficiently detailed to permit reasonable identification of the work done and conclusions reached.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

36. Since there can be significant increased costs associated with sampling, the auditor should consider alternative procedures before deciding to use sampling. Which of the following would be a good procedure to perform before resorting to sampling?
- a. Assess control risk.
 - b. Define the population.
 - c. Determine individually significant dollar items.
37. When identifying unusual items, which of the following categories is most difficult for an auditor to recognize?
- a. Program requirements.
 - b. Unusual characteristics.
 - c. Analytical procedure results.
 - d. Prior experience.
38. What is the second step for a nonstatistical sampling approach to substantive tests of compliance?
- a. Assess the risk of material noncompliance.
 - b. Consider the amount of expected possible noncompliance in the population to be sampled.
 - c. Assess appropriate tolerable noncompliance level.
 - d. After items to be examined 100% have been removed, estimate the population balance.
39. How is a sample size calculated?
- a. Dividing the population by the number of sample items.
 - b. Dividing the total population to be sampled by the tolerable noncompliance and multiply the result by the risk factor.
 - c. Dividing all items that are greater than or equal to tolerable noncompliance by the applicable risk factor.
 - d. Subtracting the individually significant and unusual items from the total population being tested.
40. Which of the following combinations is the risk of material noncompliance?
- a. Remaining balance to tolerable noncompliance.
 - b. Inherent risk times control risk.
 - c. Dollar value of remaining population divided by tolerable noncompliance times risk factor.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

36. Since there can be significant increased costs associated with sampling, the auditor should consider alternative procedures before deciding to use sampling. Which of the following would be a good procedure to perform before resorting to sampling? **(Page 235)**
- a. Assess control risk. [This answer is incorrect. Assessing control risk is a step that is performed when testing controls using audit sampling.]
 - b. Define the population. [This answer is incorrect. Defining the population is a step in performing sampling.]
 - c. **Determine individually significant dollar items. [This answer is correct. Sufficient individually significant items often can be tested to adequately reduce most misstatements and thus avoid sampling.]**
37. When identifying unusual items, which of the following categories is most difficult for an auditor to recognize? **(Page 236)**
- a. Program requirements. [This answer is incorrect. Program requirements are not considered a category used by auditors to identify unusual items.]
 - b. **Unusual characteristics. [This answer is correct. Identifying unusual characteristics is naturally difficult. This category includes most of the characteristics that the auditor identifies as worth investigating. Another difficulty is that the auditor may determine that a category of items is unusual because of concern with compliance with specific laws, regulations, and provisions of contracts and grant agreements.]**
 - c. Analytical procedure results. [This answer is incorrect. Analytical procedures can be used to identify individually significant items and populations that need to be sampled. The downside to using analytical procedures to identify individually significant items is not the level of difficulty, but the auditor often obtains minimal assurance from the review procedure results.]
 - d. Prior experience. [This answer is incorrect. Using prior experience to identify unusual items is not a difficult task. An auditor may use his or her prior experience with the client in identifying items that are highly susceptible to noncompliance. By using this approach; the auditor can save time by going directly to the problem.]
38. What is the second step for a nonstatistical sampling approach to substantive tests of compliance? **(Page 240)**
- a. **Assess the risk of material noncompliance. [This answer is correct. Assessing the risk of material noncompliance is step 2 of applying the nonstatistical approach to substantive tests of compliance. The qualitative levels of risks are high, moderate, or low.]**
 - b. Consider the amount of expected possible noncompliance in the population to be sampled. [This answer is incorrect. This is step 5 of the process. If noncompliance exceeds 1/3 of tolerable noncompliance, sampling is not recommended at this step.]
 - c. Assess appropriate tolerable noncompliance level. [This answer is incorrect. This is the first step of the process.]
 - d. After items to be examined 100% have been removed, estimate the population balance. [This answer is incorrect. This is step 4 of the process. This amount should be quantified.]

39. How is a sample size calculated? **(Page 242)**

- a. Dividing the population by the number of sample items. [This answer is incorrect. This is how sampling interval use is calculated.]
- b. Dividing the total population to be sampled by the tolerable noncompliance and multiply the result by the risk factor. [This answer is correct. An auditor can increase a sample size to 100% if the sample size is especially small. However, to calculate the sample size, the auditor must divide the total sample population by the tolerable noncompliance then multiply the results by the risk factor.]**
- c. Dividing all items that are greater than or equal to tolerable noncompliance by the applicable risk factor. [This answer is incorrect. This is how individually significant items are identified.]
- d. Subtracting the individually significant and unusual items from the total population being tested. [This answer is incorrect. This is how the remaining balance is calculated.]

40. Which of the following combinations is the risk of material noncompliance? **(Page 242)**

- a. Remaining balance to tolerable noncompliance. [This answer is incorrect. This combination assists the auditor in determining if he will need to apply additional audit procedures to the remaining account balance.]
- b. Inherent risk times control risk. [This answer is correct. The combination of inherent risk (the nature of the item) and control risk (reduced by strong controls) equals the risk of material noncompliance.]**
- c. Dollar value of remaining population divided by tolerable noncompliance times risk factor. [This answer is incorrect. This is the formula for calculating sample size.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (GSATG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

22. Why is it important to test controls?
- a. To support the auditor's assessment of control risk at less than high; and obtain appropriate audit evidence regarding if internal controls used in administering federal awards are being properly applied.
 - b. To apply audit procedures to test whether the internal controls used in administering federal award programs are functioning in accordance with prescribed procedures; and apply audit procedures to test compliance for each major federal program.
 - c. To reduce the assessed level of control risk; and restrict the auditor's substantive tests of compliance related to the awards.
 - d. To obtain an understanding of the nature of the transactions; and reach a conclusion that applies to the entire balance or class of transactions.
23. When relating population to test objectives, how does a sampling unit differ from a population?
- a. The individual items in the sampling units represent the components of the population.
 - b. A sampling unit constitutes the portion of the balance or class being tested.
 - c. The individual items in a population include payroll checks and grant expense checks.
 - d. One determination of the population is that the auditor should consider if the population produces an efficient sampling plan.
24. What is the main conceptual difference between a statistical and nonstatistical sample?
- a. Statistical sampling uses the rule of thumb for individually significant dollar items.
 - b. Nonstatistical sampling risk is objectively measured using the underlying theory of attribute sampling.
 - c. Sampling risk is objectively determined using the probability theory under the statistical sample.
 - d. Nonstatistical sampling uses a random-based method of choosing a sample.
25. Which of the following requires auditors to perform tests of controls?
- a. AICPA Audit Guide.
 - b. OMB Circular A-133.
 - c. SAS No. 111.
 - d. SAS No. 39.

26. When performing the triple-purpose tests, what sample size is necessary to fulfill any of the three purposes of the test?
- a. The smallest sample size.
 - b. The largest sample size.
 - c. A sample size of 50.
 - d. A sample size of 25%.
27. In regards to selecting and performing tests of controls, generally, when is sampling not efficient?
- a. When the expected rate is < 25% of the tolerable rate.
 - b. When the tolerable rate is > 25% of the expected rate.
 - c. When the expected rate is > 50% of the tolerable rate.
 - d. When the tolerable rate is < 50% of the expected rate.
28. When determining the sample size, which of the following generally is considered the most significant population characteristic?
- a. Expected deviation rate.
 - b. Population size.
 - c. Tolerable rate.
 - d. Level of control risk.
29. Joni is performing a single audit of Chachi's Stars for Kids, Inc. While sampling for tests of controls to determine a sample size and evaluation of sample results, Joni chooses a sample size of 25 with zero planned deviations. According to Exhibit 2-2, what is the assessed level of control risk?
- a. High.
 - b. Moderate.
 - c. Low.
 - d. Zero.
30. If Joni, in the example above, chooses a sample of 60 with two deviations, what is the assessed level of control risk?
- a. High.
 - b. Moderate.
 - c. Low.
 - d. Zero.

31. What should the population be for sampling to be efficient?
- a. ≤ 50 .
 - b. > 50 .
 - c. ≤ 100 .
 - d. > 100 .
32. Because of the increased cost that may be associated with sampling, it is pertinent that the auditor consider the _____ before determining that the sample is necessary.
- a. Effectiveness of alternative approaches.
 - b. Entity's compliance with laws and regulations.
 - c. Tolerable rate.
 - d. Nature of the controls.
33. What percent of the total expenditures for each major program is tolerable noncompliance determined to be?
- a. 5%.
 - b. 10%.
 - c. 15%.
 - d. 25%.
34. What should the balance be compared to once the auditor has computed the remaining balance?
- a. Actual rate of deviations.
 - b. Total projected questioned costs.
 - c. Tolerable noncompliance.
 - d. Sample size for a nonstatistical sampling.
35. When planning for sampling in an audit, the auditor should always consider which of the following?
- a. That statistical sampling will almost always be the most efficient approach.
 - b. That the Yellow Book requires the auditor to use sampling in a single audit.
 - c. The evidence obtained by applying substantive procedures to individually significant transactions or items.
 - d. The evidence obtained from discussions with the company's chief financial officer.
36. When applying a nonstatistical approach to substantive tests of compliance adjusting the sample size for items previously tested is which step of the process?
- a. Step 3.
 - b. Step 6.
 - c. Step 7.
 - d. Step 8.

37. How are individually significant dollar items defined?
- a. All items $< \frac{1}{3}$ of tolerable noncompliance.
 - b. All items $\leq \frac{1}{3}$ of tolerable noncompliance.
 - c. All items $= \frac{1}{3}$ of tolerable noncompliance.
 - d. All items $\geq \frac{1}{3}$ of tolerable noncompliance.
38. In a statistical sample, actual sampling risk can be measured based on _____.
- a. Prior experience.
 - b. Sample results.
 - c. Knowledge of the characteristics of the population.
 - d. The statistical theory of attribute sampling.
39. When testing compliance in a single audit, the auditor is concerned with the dollar amount of noncompliance and _____.
- a. Identifying individually significant items.
 - b. Nonstatistical or statistical sampling.
 - c. Applicable laws and regulations and the provisions of contracts or grant agreements.
 - d. The rate of noncompliance in the population.
40. Even though SAS No. 39 does not impose specific documentation requirements for audit sampling, SAS No. 103 requires which of the following?
- a. That the audit documentation is sufficient to document that the applicable field work standards have been acknowledged.
 - b. That tests of controls over federal program compliance requirements be planned to support a low level of assessed control risk.
 - c. That the auditor performs tests of controls.
 - d. That the auditor considers the expected rate of deviation from a particular control.

GLOSSARY

Audit sampling: The application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.

Audit strategy: The auditor's operational approach to achieving the objectives of the audit.

Cluster of programs: A grouping of closely related programs sharing common compliance requirements.

Cognizant agency: Federal cognizant agencies are assigned for states and larger local governmental entities, and for the subdivisions of each, by the Office of Management and Budget (OMB) to oversee implementation of the single audit.

Control risk: The risk that a material misstatement that could occur in a relevant assertion will not be prevented or detected on a timely basis by the entity's internal controls.

Detection risk: The risk that the auditor will not detect a material misstatement that exists in a relevant assertion.

Deviation: Departure from the prescribed control policy or procedure.

Expected rate: The rate of deviations the auditor expects based on prior experience and knowledge of the characteristics of the population.

Haphazard selection: Under this method, nonstatistical sample items are selected in no specific pattern without bias for or against any items in the population.

Inherent risk: The susceptibility of a relevant assertion to a material misstatement, assuming that there are no related internal controls.

Known noncompliance: Noncompliance that the auditor detects when applying auditing procedures.

Oversight agency: 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.

Population: The class of transactions being sampled.

Random selection: Regardless of the method of sampling used, statistical or nonstatistical, a random selection provides each item in the population an equal chance of being selected.

Risk of assessing control risk too low: The auditor's allowable risk of assessing control risk too low.

Systematic sampling: This method can be used with nonstatistical or statistical sampling to give every item in the population an equal chance of being selected if a random start is used.

SAS No. 99, definition of fraud: An intentional act that results in a material misstatement in financial statements that are the subject of an audit.

Tolerable rate: The maximum rate of deviations that would still support the planned assessed level of control risk.

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COMPANION TO PPC'S GUIDE TO SINGLE AUDITS

COURSE 3

CONCLUDING THE SINGLE AUDIT AND REPORTING UNDER THE SINGLE AUDIT
(GSATG093)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses how to summarize and evaluate the overall results of audit tests. It also covers the various audit reports that are unique to single audits.
PUBLICATION/REVISION DATE:	June 2009
RECOMMENDED FOR:	Users of <i>PPC's Guide to Single Audits</i>
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of governmental auditing.
CPE CREDIT:	7 QAS Hours, 7 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

Yellow Book CPE Credit: This course is designed to assist auditors in meeting the continuing education requirements included in GAO's Government Auditing Standards.

FIELD OF STUDY:	Auditing (Governmental)
EXPIRATION DATE:	Postmark by July 31, 2010
KNOWLEDGE LEVEL:	Basic

Learning Objectives:**Lesson 1—Concluding the single audit**

Completion of this lesson will enable you to:

- Explain the purpose of a management representation letter and how the accumulated results of audit procedures are determined.
- Summarize and evaluate how workpapers are reviewed the overall results of audit tests, and the drafting of the financial statements.
- Prepare the data collection form without identified errors.
- Explain the purpose of an exit conference and client communications and communicate opinions and other significant matters in oral and written reports.

Lesson 2—Reporting under the single audit

Completion of this lesson will enable you to:

- Explain how to date an auditor's report and determine when audit reports are due, who is responsible for submitting the reports, to whom and where the reports should be submitted, and what reports should be submitted.
- Compose a report on internal control over financial reporting and on compliance and other matters required by *Government Auditing Standards*.
- Prepare and report on the schedule of expenditures of federal awards.
- Compose a report on compliance with requirements applicable to each major program and on internal control over compliance required by OMB Circular A-133.
- Describe the procedures an auditee uses to prepare a summary schedule of prior audit findings and distinguish between fraud or illegal acts, violations of provisions of contracts or grant agreements, and abuse; and communicate control deficiencies and other comments.
- Prepare a report of all findings meeting specified criteria in a schedule of findings and questioned costs.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
GSATG093 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Concluding the Single Audit

INTRODUCTION

In addition to the audit procedures specifically related to the single audit (e.g., procedures related to compliance and internal controls), some other procedures that are of a general nature are necessary in a single audit. The general procedures that are discussed in this course are as follows:

- Procedures to search for *commitments and contingencies*, including obtaining lawyers' letters.
- Obtaining written representations from management in the form of a *management representation letter*.

After applying audit procedures to specific financial statement components, applying single audit procedures, and completing the general procedures described above, an auditor must summarize and evaluate the overall results of audit tests, complete the data collection form, reach a conclusion on the form of opinion on the financial statements and on major program compliance, and communicate those opinions and other significant matters in written and oral reports. These final audit steps and considerations for workpaper finalization, access, and retention are discussed in this course.

Authoritative Literature

The authoritative pronouncements that establish requirements or provide suggestions that most directly affect the general procedures include the following:

- SAS No. 12 (AU 337), *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.
- SAS No. 54 (AU 317), *Illegal Acts by Clients*.
- SAS No. 74 (AU 801), *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*.
- SAS No. 85 (AU 333), *Management Representations*, as amended by SAS Nos. 89 and 99.
- SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*.
- SAS No. 103 (AU 339), *Audit Documentation*.
- SAS No. 107 (AU 312), *Audit Risk and Materiality in Conducting an Audit*.
- SAS No. 108 (AU 311), *Planning and Supervision*.
- SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.
- SAS No. 112 (AU 325A), *Communicating Internal Control Related Matters Identified in an Audit*.
- SAS No. 114 (AU 380), *The Auditor's Communication with Those Charged with Governance*.
- SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*.
- AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide).

Learning Objectives:

Completion of this lesson will enable you to:

- Explain the purpose of a management representation letter and how the accumulated results of audit procedures are determined.

- Summarize and evaluate how workpapers are reviewed the overall results of audit tests, and the drafting of the financial statements.
- Prepare the data collection form without identified errors.
- Explain the purpose of an exit conference and client communications and communicate opinions and other significant matters in oral and written reports.

COMMITMENTS AND CONTINGENCIES

Commitments and contingencies are uncompleted transactions or uncertainties that should be disclosed (and sometimes their amounts accrued) because of their effect on current financial position or future operating results. Commitments are contractual obligations for a future expenditure. Contingencies are existing conditions that create a current obligation that needs to be accrued or that might create an obligation in the future that needs to be disclosed. Contingencies arise from past transactions or events. For an audit of financial statements, the auditor's primary objectives are determining whether all significant commitments and contingencies have been identified (*completeness*), assessing their financial effect (*valuation*), and evaluating presentation and disclosure (*completeness, understandability, and valuation*). The following section focuses on commitments and contingencies that are unique to the single audit.

Numerous commitments and contingencies may affect a nonprofit or governmental entity. The primary concerns unique to a single audit, however, relate to—

- Contingencies resulting from noncompliance with program requirements, including potential termination of the program or requirements to repay questioned or disallowed costs to the funding agency.
- Commitments for awards to subrecipients payable over future periods.

The auditor should note that contingencies might also result from noncompliance with grant requirements at the subrecipient level.

Audit Procedures

Contingencies resulting from questioned costs may be detected while testing compliance with laws and regulations that govern federal awards. Other audit procedures that are often used to search for commitments and contingencies include the following:

- Inquiring of responsible officials about the possibility of unrecorded commitments or contingencies.
- Reading minutes of meetings of the governing body.
- Reading funding source agreements and related documents.
- Inquiring of the cognizant or oversight agency about potential commitments or contingencies.
- Reviewing current and past years' reports from grantor agencies, if any.
- Reviewing transactions subsequent to the balance sheet date.
- Reviewing communications from regulatory agencies such as the Environmental Protection Agency or similar federal or state agencies.
- Analyzing legal expenses and inspecting invoices from lawyers.
- Sending a letter of inquiry to legal counsel.

Lawyers' Letters

SAS No. 12 (AU 337.08) states that a letter of audit inquiry to legal counsel is the primary means of corroborating information furnished by management concerning litigation, claims, and assessments and unasserted claims and

assessments. The letter is sent to lawyers who have the primary responsibility for, and knowledge of, particular litigation, claims, or assessments. The auditor identifies lawyers who provided services on such matters and should be sent a letter by reviewing client legal files, analyzing legal and professional fees and invoices, and inquiring of management.

In addition to the information usually included in the standard request for legal representation, the auditor should consider inquiring about demands for repayment of federal funds due to violations of grant requirements.

The information discussed above should be requested in the standard request for legal representation that is sent as part of the financial statement audit. When a request for legal representation is not sent, information related to demands for repayment of federal funds should be obtained through discussions with management and the cognizant or oversight agency for audit.

If a request for legal representation is sent, the letter should request the lawyer to respond as of a date reasonably close to the date of the auditor's reports (for example, within two weeks of the anticipated report date). Specifying the effective date of the lawyer's response to reasonably approximate the report date will, in most instances, eliminate the need for an updated response from the lawyer. However, when the audit of federal awards is performed subsequent to the audit of the financial statements, the auditor might want to confirm the continued appropriateness of the lawyer's response as of a date nearer to the date of the single audit reports.

The legal request should specify a materiality limit so the lawyer knows what items are to be considered material, individually or in the aggregate, for the response. For a single audit, the materiality amount should be a fraction of planning materiality for the smallest major program. Using such an amount should result in a response that will allow the auditor to issue an opinion on compliance for *each* major program. The specific amount used is a matter of auditor judgment based on knowledge of the client and other factors.

In some cases, the governmental or nonprofit organization may not have consulted a lawyer about litigation, claims, or assessments during the period. In such a case, this course suggests that the auditor obtain a written representation from management stating that the organization has not consulted with an attorney.

MANAGEMENT REPRESENTATION LETTER

SAS No. 85 (AU 333.01), *Management Representations*, requires the auditor to obtain written representations from responsible client officials. The letter, among other things, confirms oral representations about specific matters given to the auditor during the audit. It is part of the audit evidence the auditor obtains; however, it is not a substitute for other necessary audit procedures to corroborate information about matters for which written representations are obtained.

The importance of obtaining a management representation letter is emphasized when an auditor's inability to obtain appropriate written representations prevents the auditor from expressing an unqualified opinion and may cause the auditor to disclaim an opinion or even withdraw from the engagement.

Periods Covered by the Letter

SAS No. 85 (AU 333.05) states that representations should be obtained from current management for all financial statements and periods covered by the auditor's report. For example, if the current year's auditor's report covers the current and prior periods, the representation letter should cover both periods. The representations covered for each of the periods included in the letter will depend on the circumstances. For example, a representation regarding a financial statement disclosure that is required only as of the current financial statement date (and not the prior year date) need cover only the current financial statement date.

Written Representations to Be Obtained

A management representation letter is usually prepared by an auditor, but is a communication from the client to the auditor and is signed by client management. SAS No. 85 (AU 333.06) provides a list of specific representations that should be obtained. Even though certain written representations are specifically required, other authoritative

pronouncements also require representations. In addition, AU 333.05 states that the letter should be tailored to meet the client's individual circumstances.

SAS No. 85 requires the representation letter to include an acknowledgment that management has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. SAS No. 85, as amended, also requires that a summary of the uncorrected misstatements be included in or attached to the representation letter.

Reliance on Management Representations

The auditor is required to obtain written representations from management. However, the auditor should not simply accept management's representations as the only necessary audit evidence for significant matters. If the auditor cannot verify a representation using another form of evidence, the auditor should evaluate whether the representation is feasible considering past history with the client and the current economic conditions. In addition, if other audit evidence contradicts a representation made by management, the auditor should investigate the circumstances and consider the reliability of the representation. Depending on the circumstances, the auditor may need to consider whether reliance on management's representations relating to other aspects of the financial statements is appropriate.

Modifications for a Single Audit

In the representation letter, officials of the organization acknowledge their primary responsibility for the financial statements and provide other representations that are "ordinarily" obtained according to SAS No. 85 (e.g., representations that all minutes and financial records were made available to the auditor, that there are no plans or intentions that might materially affect the financial statements, etc.). In addition to items specified in SAS No. 85, and to the representations normally obtained in a governmental or nonprofit audit, the letter should include any other matters that are unique to the single audit.

Paragraph 3.37 of the GAS/A-133 AICPA Audit Guide indicates that with respect to the financial statement audit performed under GAAS and the Yellow Book, auditors should consider obtaining additional representations from management acknowledging that—

- Management is responsible for compliance with the laws, regulations, and provisions of contracts and grant agreements applicable to the auditee.
- Management is responsible for establishing and maintaining effective internal control over financial reporting.
- Management 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.
- Management 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.
- Management 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 required by 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.)
- Management 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.
- Management has a process to track the status of audit findings and recommendations.

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

In a single audit, the auditor is concerned with the organization's compliance with requirements that, if not complied with, could have a direct and material effect on a major federal program, not just on the basic financial statements. Thus, additional representations are advisable and should be added to the representation letter obtained in connection with the audit of financial statements.

Paragraph 10.67 of the GAS/A-133 AICPA Audit Guide indicates that with respect to compliance requirements affecting federal awards, auditors should consider obtaining representations that—

- Management is responsible for complying, and has complied, with the requirements of OMB Circular A-133.
- Management has prepared the schedule of expenditures of federal awards in accordance with OMB 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 has 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.
- 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 OMB Circular A-133.
- If applicable, management has issued management decisions on a timely basis 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 entity'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 OMB 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.

In addition, for Yellow Book audits, additional representations may be needed when the auditor participates in drafting the financial statements and notes or prepares the trial balance.

Materiality

SAS No. 85 (AU 333) permits, but does not require, limiting representations to matters that are either individually or collectively material to the financial statements. That limitation is acceptable, however, only for representations that directly relate to amounts included in the financial statements and only if the auditor and management reach an agreement about what is material for this purpose. SAS No. 85 (AU 333) notes that materiality may be different for different representations, and it permits but does not require including an explicit discussion of materiality in the representation letter, in either qualitative or quantitative terms. A discussion that includes both qualitative and quantitative terms is also acceptable. However, this course discourages using a purely quantitative discussion of materiality because it is inappropriate to rely solely on quantitative considerations when determining materiality.

The writers of this course do not believe the quantitative approach is practical with respect to federal award programs for a single audit. In those instances, the discussion should be tailored to reflect the requirements of OMB Circular A-133.

Materiality considerations would not apply to representations that have no direct relationship to financial statement (including notes thereto) amounts or to representations regarding information concerning fraud. Examples of representations that have no direct relationship to financial statement amounts include management's acknowledgment of its responsibility—

- For the fair presentation of governmental financial statements in conformity with U.S. generally accepted accounting principles.

- For the fair presentation in nonprofit financial statements of financial position, changes in net assets, and cash flows in conformity with U.S. generally accepted accounting principles.
- To make available all financial records and related data and communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
- For the completeness and availability of all minutes of meetings of governing bodies.
- Related to communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
- Related to information on fraud involving (a) management, (b) employees who have significant roles in internal control, or (c) others where the fraud could have a material effect on the financial statements.

Audit Adjustments

SAS No. 85 (AU 333) requires an acknowledgment in the representation letter that management has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of the uncorrected misstatements should be included in or attached to the representation letter.

The communication of audit adjustments in the representation letter does not constitute a communication under SAS No. 54, *Illegal Acts by Clients* (AU 317), or SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU 316). The auditor may have additional communication responsibilities under those standards. In addition, the auditor may consider the client's decision to not record the audit adjustments when identifying and assessing fraud risk. However, the decision to not record all proposed adjustments does not necessarily mean the client is intentionally misstating the financial statements.

Addressee, Date, and Signees

The auditor should be concerned with matters occurring through the date of his or her report, not merely through the financial statement date. As a result, the representation letter should be dated as of the date of the auditor's report. AICPA Technical Practice Aid, *The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report* (TIS 9100.06-.07), clarifies that the requirement does not mean that the auditor needs to physically have management's representation letter on the date of the auditor's report. However, on or before the date of the auditor's report, management will need to have reviewed the final representation letter and confirmed to the auditor that they will sign the letter. The auditor will need to have the signed management representation letter prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

If the auditor's report is dual dated due to the disclosure of a subsequent event, the auditor should consider obtaining additional representations relating to the subsequent event. In instances where a separate letter is obtained for compliance requirements affecting major federal awards, that letter should be dated no earlier than the date of the auditor's report on compliance issued in accordance with OMB Circular A-133.

For a governmental entity, the letter generally should be signed by the chief executive officer and the chief financial officer; e.g., the mayor, city manager, school superintendent and the finance officer, school district business manager. For a nonprofit organization, the letter generally should be signed by the executive director or president, controller (or the individual fulfilling an equivalent position), and chairman of the governing board. However, according to SAS No. 85 at AU 333.09, the letter should be signed by ". . . members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered in the representations." Paragraph 3.37 of the GAS/A-133 AICPA Audit Guide provides similar guidance. Paragraph 3.37 notes that these members of management will normally include the chief executive officer, chief financial officer, or others in equivalent positions (e.g., management of component units). In addition, auditors may also consider obtaining representations from other officials relating to specific areas (e.g., the recording secretary of the governing body about whether the minutes are complete for all meetings held during the audit period and through the date of the auditor's report).

SAS No. 85 at AU 333.10 makes it clear that appropriate representations should be obtained from *current management* covering all of the periods, even if current management was not present during all such periods. However, it indicates that the specific representations will depend on the circumstances. While not specifically mentioned in the SAS, it is believed it may be appropriate in some instances to obtain certain representations from officials other than those signing the standard letter.

The auditor of a governmental unit may have a problem obtaining a representation letter if the responsible administrative official is elected for a term that differs from the governmental unit's financial reporting year. A newly elected individual may be reluctant to sign representations relating to the period prior to the beginning of his or her term of office. The official may be reluctant to sign the letter if he or she obtains supporting representations from other key officials or employees who were responsible for financial matters during the period in question. If the auditor believes such a problem is possible because of expected changes in the administration, the auditor should consider and resolve the problem before beginning the engagement and should include the expected manner of resolution in the engagement letter.

In some instances, it may be preferable to obtain certain representations from officials other than those signing the standard letter. For example, some auditors obtain a separate letter concerning the completeness of the minutes from the clerk responsible for keeping the minutes for the legislative body or governing board. It may also be appropriate to obtain representations from the management of component units and of large or autonomous agencies and departments in the reporting entity. Auditors of component units, or other units or funds who are not also auditors of the primary governments, should consider obtaining representations from management of primary governments concerning matters that may affect the unit they are auditing. Such matters might include information regarding intergovernmental transactions and related party transactions. The need to obtain such representations is a matter of professional judgment.

Scope Limitations

It is clear from SAS No. 85 at AU 333.13 that management's refusal to furnish written representations is a limitation on the scope of the engagement sufficient to preclude an unqualified opinion. It further states that it is "ordinarily" sufficient to require a disclaimer of opinion or to withdraw from the engagement, but that based on the specific representations not obtained or the circumstances of the refusal, it may, in some cases, be appropriate to conclude that only a qualified opinion is necessary. It is believed that situations resulting in a qualified opinion (as opposed to a disclaimer or withdrawal) will be limited to those where only one or perhaps a few representations are refused. Paragraph 10.68 of the GAS/A-133 AICPA Audit Guide also states that management's refusal to furnish all written representations that the auditor considers necessary in the circumstances constitutes a scope limitation sufficient to require a qualified opinion or a disclaimer of opinion on compliance with major program requirements. In addition, the auditor should consider his or her ability to rely on other management representations because of management's refusal to furnish a written representation.

Even if a written representation is obtained regarding a matter, there is a limitation on the scope of the audit if the auditor is prevented from performing other procedures he or she considers necessary relating to the same matter. In those instances, the auditor must consider the need for a qualified opinion or disclaimer of opinion.

CONSIDERING THE ACCUMULATED RESULTS OF AUDIT PROCEDURES

Reevaluating Risk Assessments

The auditor's assessment of audit risk made during planning a single audit is based on available audit evidence and naturally may change as additional evidence is obtained. The consideration of audit risk includes an assessment of the risk of material misstatement resulting from violations of laws and regulations that may have a direct and material effect on the determination of financial statement amounts. For a single audit, the consideration also includes an assessment of the risk that the entity has not complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each major program.

In performing substantive procedures, the auditor may identify misstatements that are larger or more frequent than had been anticipated. In this situation, SAS No. 110 (AU 318.70) requires the auditor to reevaluate whether the

assessment of risks of material misstatement at the relevant assertion level remains appropriate. The audit evidence may either confirm the auditor's risk assessments or result in the auditor performing additional audit procedures.

At the end of the audit, the auditor concludes whether sufficient appropriate audit evidence was obtained to reduce the risk of material misstatement in the financial statements to an appropriately low level and to support the opinion on the financial statements. This requires the auditor to evaluate whether the audit was performed at a level that provides the auditor with a high level of assurance that the financial statements, taken as a whole, are free of material misstatement. The auditor's consideration in a single audit is similar to the consideration in a financial statement audit. In other words, the auditor also concludes whether sufficient appropriate audit evidence was obtained to limit the risk of material noncompliance to an appropriately low level and to support the opinion on compliance. The sufficiency and appropriateness of audit evidence is a matter of the auditor's professional judgment. SAS No. 110 (AU 318.75) states that the auditor's judgment is influenced by factors such as—

- Significance of the potential misstatement in the relevant assertion and the likelihood of it having a material effect on the financial statements—both individually and when aggregated with other misstatements.
- Effectiveness of management's responses and controls to address the risks.
- Experience gained during previous audits with respect to similar potential misstatements.
- Results of audit procedures, including whether specific instances of fraud or error were identified.
- Reliability and source of available information.
- Persuasiveness of the audit evidence.
- Understanding of the entity and its environment, including its internal control.

SAS No. 110 (AU 318.76) states that if the auditor has not obtained sufficient appropriate audit evidence with respect to a material financial statement assertion, the auditor should try to obtain additional evidence. If the auditor cannot obtain sufficient appropriate audit evidence, the auditor should either express a qualified opinion or disclaim an opinion.

Evaluating the Existence of Fraud

At or near the completion of fieldwork, the auditor should evaluate the accumulated results of audit procedures and other conditions noted during the audit to determine their effect on the auditor's previous assessment of risks. Based on the evaluation, the auditor determines whether additional or different audit procedures are necessary. In addition, the auditor should perform a qualitative evaluation of misstatements identified in the financial statements and determine whether the misstatements may indicate possible fraud. The auditor with final responsibility for the audit should ascertain there has been adequate communication with the engagement team throughout the audit about information or conditions that indicate potential risks of material misstatement due to fraud. One way of doing this would be to hold another engagement team meeting.

Evaluating Significant Unusual Transactions. Additional substantive procedures that may be needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances. Because of the judgmental nature of the auditor's risk assessments and the inherent limitations of internal control, particularly the risk of management override, some substantive procedures have to be performed in every audit. One of those procedures involves evaluating significant unusual transactions.

SAS No. 99 requires the auditor to evaluate the business rationale for significant unusual transactions to address the risk of management override of controls (AU 316.66). The auditor should consider whether the business rationale (or lack thereof) suggests that transactions may have been entered into to perpetrate fraudulent financial reporting or conceal misappropriation of assets.

Considering the Application of Significant Accounting Principles for Bias. The auditor should consider whether the application of significant accounting principles indicates a bias on the part of management. In

particular, the auditor should consider accounting related to subjective measurements and complex transactions. Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure is one way in which fraudulent financial reporting can be accomplished.

Additional Government Auditing Standards Requirements. The Yellow Book, at Paragraph 4.11, requires the auditor to apply additional procedures if evidence of possible violations of provisions of contracts or grant agreements that could have a material indirect effect on the financial statements comes to the auditor's attention. If the auditor subsequently concludes that a violation has occurred or is likely to have occurred, the auditor should determine the implications for other aspects of the audit, as well as the effect on the financial statements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. What is the primary means of confirming information provided by management regarding claims and assessments and unasserted claims and assessments?
 - a. Letter of audit inquiry to legal counsel.
 - b. Management representation letter.
 - c. Reviewing of funding source agreements.
 - d. Review of past years' reports from grantor agencies.
2. Asia is in the process of concluding an audit. She prepared a tailored management representation letter which covers the current period and had it signed by the client's management. Asia then verified the representation. The audit report Asia is about to issue covers both the current and prior year's financial statements. Based on the information given, what mistake has Asia made?
 - a. The management representation letter should only include representations that are specifically required.
 - b. The representation letter is the only audit evidence needed for significant matters and there was no need for it to be verified.
 - c. The management representation letter should have covered the same periods as the auditor's report.
3. Who is a qualified signer for a governmental entity's management representation letter?
 - a. Chairman of the governing board.
 - b. Chief financial officer.
 - c. Controller.
 - d. Executive director.
4. Ashleigh is in the process of concluding an audit of a governmental unit. She has obtained written representations from management and there have been no limitations on the scope of the audit. Based specifically on the scope, how should Ashleigh proceed?
 - a. Issue an unqualified opinion.
 - b. Withdraw from the engagement.
 - c. Issue a disclaimer of opinion.
 - d. Issue a qualified opinion.

5. SAS No. 99 requires an auditor to perform which of the following?
- a. Reevaluate if the assessment of risks of material misstatement at the relevant assertion level remains appropriate.
 - b. Acknowledge in the representation letter that management has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented.
 - c. Apply additional procedures if the auditor becomes aware of evidence of possible violations of provisions of contracts that could have a material indirect affect on the financial statements.
 - d. Evaluate the business rationale for significant unusual transactions to address the risk of management override of controls.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. What is the primary means of confirming information provided by management regarding claims and assessments and unasserted claims and assessments? **(Page 264)**
 - a. **Letter of audit inquiry to legal counsel.** [This answer is correct. SAS No. 12 states that a letter of audit inquiry to legal counsel is the primary means of corroborating information furnished by management concerning litigation, claims, and assessments and unasserted claims and assessments. The letter is sent to lawyers who have the primary responsibility for, and knowledge of, particular litigation, claims, or assessments.]
 - b. Management representation letter. [This answer is incorrect. The purpose of a management representation letter is, on part, to confirm oral representations about specific matters given to the auditor during the audit.]
 - c. Reviewing of funding source agreements. [This answer is incorrect. Reading funding source agreements and related documents is an audit procedure used to search for commitments and contingencies, however, this specific audit procedure is not the primary means of confirming information provided by management regarding claims and assessments and unasserted claims and assessments.]
 - d. Review of past years' reports from grantor agencies. [This answer is incorrect. Reviewing current and past years' reports from grantor agencies are audit procedures used to search for commitments and contingencies, however, these specific audit procedures are not the primary means of confirming information provided by management regarding claims and assessments and unasserted claims and assessments.]
2. Asia is in the process of concluding an audit. She prepared a tailored management representation letter which covers the current period and had it signed by the client's management. Asia then verified the representation. The audit report Asia is about to issue covers both the current and prior year's financial statements. Based on the information given, what mistake has Asia made? **(Page 265)**
 - a. The management representation letter should only include representations that are specifically required. [This answer is incorrect. Even though certain written representations are specifically required, other authoritative pronouncement also require representations. Therefore, the letter should be tailored to meet the client's individual circumstances.]
 - b. The representation letter is the only audit evidence needed for significant matters and there was no need for it to be verified. [This answer is incorrect. An auditor should not simply accept management's representations as the only necessary audit evidence for significant matters.]
 - c. **The management representation letter should have covered the same periods as the auditor's report.** [This answer is correct. SAS No. 85 states that the representation letter should be obtained for all financial statements and periods covered by the auditor's report. Therefore, the representation letter should cover both the current and prior year.]
3. Who is a qualified signer for a governmental entity's management representation letter? **(Page 269)**
 - a. Chairman of the governing board. [This answer is incorrect. The chairman of the governing board is one of the persons responsible for signing the management representation letter for a nonprofit organization.]
 - b. **Chief financial officer.** [This answer is correct. For a governmental entity, the letter generally should be signed by the chief executive officer and the chief financial officer; e.g., the mayor, city manager, school superintendent and the finance officer, school district business manager.]

- c. Controller. [This answer is incorrect. The controller is one of the people responsible for signing the management representation letter for a nonprofit organization.]
 - d. Executive director. [This answer is incorrect. The executive director is one of the people responsible for signing the management representation letter for a nonprofit organization.]
4. Ashleigh is in the process of concluding an audit of a governmental unit. She has obtained written representations from management and there have been no limitations on the scope of the audit. Based specifically on the scope, how should Ashleigh proceed? **(Page 270)**
- a. **Issue an unqualified opinion.** [This answer is correct. It is clear from SAS No. 85 that if management refuses to furnish written representations a limitation on the scope of the engagement has occupied and is sufficient to preclude an unqualified opinion; however in the example given in this question Ashleigh had no problems receiving representations from management.]
 - b. Withdraw from the engagement. [This answer is incorrect. Withdrawing from an engagement is a valid option to an auditor whose client's management refuses to furnish written representations.]
 - c. Issue a disclaimer of opinion. [This answer is incorrect. When there is a limitation on the scope of the audit, even if written representations are provided, an auditor must consider the need for a qualified opinion or disclaimer of opinion.]
 - d. Issue a qualified opinion. [This answer is incorrect. A qualified opinion would be issued if one or perhaps a few representations are refused by management.]
5. SAS No. 99 requires an auditor to perform which of the following? **(Page 271)**
- a. Reevaluate if the assessment of risks of material misstatement at the relevant assertion level remains appropriate. [This answer is incorrect. SAS No. 110 requires the auditor to reevaluate whether the assessment of risks of material misstatement at the relevant assertion level remains appropriate if when performing substantive procedures, the auditor identifies misstatements that are larger and more frequent than had been anticipated. The audit evidence may either confirm the auditor's risk assessments or result in the auditor performing additional audit procedures.]
 - b. Acknowledge in the representation letter that management has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented. [This answer is incorrect. SAS No. 85 requires an acknowledgment in the representation letter that management has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.]
 - c. Apply additional procedures if the auditor becomes aware of evidence of possible violations of provisions of contracts that could have a material indirect effect on the financial statements. [This answer is incorrect. The 2007 Yellow Book, at Paragraph 4.11, requires the auditor to apply additional procedures if evidence of possible violations of provisions of contracts or grant agreements that could have a material indirect effect on the financial statements comes to the auditor's attention. If the auditor subsequently concludes that a violation has occurred or is likely to have occurred, the auditor should determine the implications for other aspects of the audit, as well as the effect on the financial statements.]
 - d. **Evaluate the business rationale for significant unusual transactions to address the risk of management override of controls.** [This answer is correct. SAS No. 99 requires the auditor to evaluate the business rationale for significant unusual transactions to address the risk of management override of controls. The auditor should consider whether the business rationale (or lack thereof) suggests that transactions may have been entered into to perpetrate fraudulent financial reporting or conceal misappropriation of assets.]

REVIEW OF WORKPAPERS

The review of workpapers near the conclusion of the engagement has two stages: (a) detailed review of the audit work of staff assistants and (b) a higher level supervisory review. Although an audit senior usually reviews the work of staff assistants and a manager or partner usually makes a supervisory review, there is considerable variation in practice. For example, in some small engagements, the audit senior may be the only staff person working on the engagement.

Authoritative pronouncements establish only broad requirements for supervision and review. SQCS No. 7, *A Firm's System of Quality Control* (QC 10.60–.61), indicates that a firm should establish policies and procedures that address supervision and review responsibilities. The review responsibility policies and procedures should be determined on the basis that qualified engagement team members review the work performed by other team members on a timely basis. The review may include consideration of factors such as whether—

- The audit work has been performed in accordance with professional standards and any applicable regulatory and legal requirements.
- Significant findings and issues have been considered.
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented.
- The nature, timing, and extent of work performed are sufficient and appropriate.
- The work performed supports the conclusions reached and is appropriately documented.
- The evidence obtained is sufficient and appropriate to support the auditor's report.
- The objectives of the engagement procedures have been achieved.

SAS No. 108 (AU 311.28–.32), provides the following guidance on supervision and review of the engagement:

- The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work, including knowledge of the client's business and industry.
- The auditor with final responsibility for the audit should direct assistants to bring to his or her attention accounting and auditing issues raised during the audit that the assistant believes are significant to the financial statements or auditor's report so that the auditor may assess their significance. Assistants should also be instructed to bring to the attention of appropriate individuals in the firm difficulties encountered when performing the audit, such as missing documents or client resistance in responding to inquiries or providing access to information.
- The work performed by each assistant and the documentation of the work should be reviewed to determine whether the work was adequately performed and documented and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report. The auditor with final responsibility may delegate parts of the review responsibility to other assistants, in accordance with firm quality control policies.
- If differences of opinion concerning accounting or auditing issues exist among firm personnel, an assistant should be able to document disagreement with the resolution of a matter. The auditor with final responsibility for the audit and assistants should be aware of the procedures to be followed when there are differences of opinion among the auditors about accounting and auditing issues. Also, assistants have a professional responsibility to bring disagreements or concerns that they have with respect to accounting and auditing issues that they believe are significant to the financial statements or the auditor's report to the attention of appropriate individuals in the firm.

SAS No. 103, *Audit Documentation*, points out that one of the purposes of audit documentation is to aid the auditor in the direction, supervision, and review of the audit. Auditors are required to document *who* performed the work and *when* the work was completed. Likewise, the workpapers should indicate *who* reviewed the work and the *date* of the review. These requirements do not mandate any specific arrangements for engagement administration.

One primary implication is that there must be some mechanism to assure that significant accounting or auditing problems identified in the audit work or detailed review are brought to the attention of the supervisory reviewer. Also, there should be some mechanism for dealing with and resolving differences of opinion. SQCS No. 7 (QC 10.78), indicates that an audit firm's policies and procedures for dealing with and resolving differences of opinion should require that (1) conclusions reached should be documented and implemented and (2) the audit report should not be released until the matter is resolved. According to AU 311.32, the firm's procedures should also allow an assistant to document his or her disagreement with the conclusions reached if, after appropriate consultation, he or she believes it necessary to disassociate himself or herself from the resolution of the matter. In this situation, the basis for the final resolution should also be documented.

Detailed Review of Audit Work

The objectives of the detailed review of audit work are to ensure there is—

- a. Adherence to professional standards and firm policies and practices.
- b. Integration of results and conclusions from work on individual financial statement components and on individual financial assistance programs.
- c. Proper summarization of the results of audit tests, including significant audit findings or issues, for the attention of the supervisory reviewer and for potential inclusion in the single audit reports.

In general, the reviewer should determine whether the audit documentation would permit an experienced auditor who has no previous connection with the engagement to understand (a) the nature, timing, and extent of the auditing procedures performed; (b) the results of the audit procedures and the evidence obtained; (c) the conclusions reached on significant matters; and (d) that the audited financial statements and schedule of expenditures of federal awards agree or reconcile to the accounting records.

The detailed review of the current workpaper file usually includes the following:

- a. For each financial statement component and for each financial program, review the supporting schedules to ensure:
 - (1) Each workpaper is complete and properly headed, dated, initialed, indexed, and cross-referenced to the working trial balance and, if appropriate, the schedule of expenditures of federal awards.
 - (2) Amounts agree with the amounts in the working trial balance and the schedule of expenditures of federal awards and have been traced to the general ledger.
 - (3) The audit program has been completed, as indicated by initials and dates; indexed; the conclusion signed; and the related workpaper schedules indicate that the procedures have been performed.
 - (4) Any misstatements (questioned costs), instances of noncompliance, abuse, and deficiencies in internal control that were discovered during the audit have been properly identified, analyzed, and considered for inclusion in the appropriate single audit reports.
- b. For the general section of the file and the workpapers as a whole (including the permanent file), ensure that—
 - (1) Any information on a workpaper for a financial statement element that is relevant to another element has been properly considered and cross-referenced.

- (2) Any relevant information in the permanent file or other general files has been incorporated or cross-referenced.
 - (3) Any significant audit findings or issues (including discussions with management and others) have been adequately addressed and documented.
 - (4) Any unusual matters have been included in the management representation letter.
- c. Reviewing the summary schedule of prior audit findings and corrective action plan and preparing the schedule of findings and questioned costs.
 - d. Drafting the financial statements, as applicable, and the audit reports.

SAS No. 103 requires that the workpapers indicate who reviewed specific audit documentation and the date of the review. Auditors are not required to indicate their review on each specific workpaper. However, the documentation should clearly indicate who reviewed specified elements of the audit work and when. A practical and efficient way of indicating who reviewed specified elements of the audit work and when is for the detailed reviewer to initial and date the specific workpapers reviewed.

Supervisory Review

Both SAS No. 103 and *Government Auditing Standards* require the audit documentation (workpapers) to include evidence of supervisory review. Supervisory reviewers should document their review of specific audit documentation and when it occurred. Some reviewers may prefer to document their review in a memo format that indicates the specific workpaper sections reviewed and associated dates.

Government Auditing Standards establishes an additional requirement for supervisory review. Paragraph 4.20 of the 2007 Yellow Book requires auditors to document evidence of supervisory review of the work performed before the audit report is issued. According to a senior GAO official, based on the GAO's interpretation of the Yellow Book, they expect to see "supervisory" initials on "significant" workpapers, such as summary spread sheets and other "important" workpapers. The supervisory initials may be those of an owner or someone in a supervisory position. (A sole practitioner is not expected to engage another practitioner to review and initial his or her workpapers.)

Generally, the supervisory review focuses more on summary and evaluation and documentation of significant audit findings or issues, and less time and attention are given to supporting workpaper schedules. It is usually conducted after financial statements and single audit reports have been drafted and is the final check on whether the audit work supports the single audit reports and the opinions on compliance of major programs and on the financial statements. The review of the workpapers should be performed before the date of the auditor's report.

Any review notes or comments from the earlier stages of review should be satisfactorily resolved by the completion of the supervisory review. The particular practices adopted for documenting and clearing review notes are a matter of individual firm preferences in engagement administration. However, it is important that the resolution be clear and no apparent unanswered or open matters remain in the final workpapers. Once the audit has been completed, all review points and notes should be removed from the workpapers, as they do not constitute audit evidence.

Relationship of Workpaper Review to Dating of the Auditor's Report

SAS No. 103 states that the date of the auditor's report should be no earlier than the date that sufficient appropriate evidence has been obtained to support the opinion on the financial statements. Among other items, *sufficient appropriate audit evidence* includes evidence that—

- a. The audit documentation has been reviewed.
- b. The financial statements, including disclosures, have been prepared.
- c. Management has taken responsibility for the financial statements.

It is believed that both the detailed and supervisory review should be performed and evidenced prior to the date of the auditor's report.

Review Checklists

Most firms use some form of checklist to serve as a reminder of important engagement completion matters and to document completion of a review of the workpapers. The checklist is just one of many acceptable approaches to documenting supervision and review. Also, the PCIE *Uniform Initial Review Guide for A-133 Audits* and the PCIE *Uniform Quality Control Review Guide for A-133 Audits* may be utilized as quality control checklists at the end of the engagement. These checklists, although not required, may be helpful in preparing audit reports and supporting workpapers that comply with the requirements of OMB Circular A-133. However, the 1999 editions of these PCIE checklists are the most current editions available. They do not address changes to OMB Circular A-133, *Government Auditing Standards*, or AICPA guidance issued since their release in 1999. The OMB is in the process of updating these checklists and anticipates releasing the revised checklists in 2009.

Sole Practitioners

Obviously, much of this discussion on the various levels of review is not applicable to a sole practitioner who has no assistants. A sole practitioner usually has to review his or her own workpapers. Professional standards do not require that audit work necessarily be reviewed by someone other than the person who did the work. Most of what is written in authoritative pronouncements and elsewhere about supervision and review does not apply if there are no assistants. This does not mean, however, that review of completed audit work is unimportant. It is still necessary to make a critical review of completed work and evaluate whether the work performed adequately supports the conclusions reached.

Engagement Quality Control Review

Many firms require a review of the audited financial statements, schedule of expenditures of federal awards, auditor's reports, and other communications and reports by someone who has no other responsibility on the audit. Depending on firm policy, independent reviews may also include additional procedures, such as—

- a. Looking at the checklists or memoranda that document the review by the audit senior and engagement partner.
- b. Reviewing attorneys' letters and the management representation letter.
- c. Reading documentation related to the significant judgments made by the engagement team and the conclusions they reached.
- d. Discussing significant findings and issues with the engagement partner.

SQCS No. 7, *A Firm's System of Quality Control* (QC 10.80), states that a firm should establish criteria against which all audit engagements should be evaluated to determine whether an engagement quality control review should be performed. If performed, that review should be completed before the audit report is released (QC 10.81).

This course recommends that an engagement quality control review be performed on each single audit by someone with single audit experience.

SUMMARIZATION AND EVALUATION

One of the final steps near completion of the engagement is evaluation of the findings and items of noncompliance detected in fieldwork. While summarization and evaluation procedures for the single audit and the audit of the financial statements should be coordinated and, if possible, performed concurrently, this course does not include a detailed discussion of summarizing and evaluating audit differences typically found in an audit of financial statements. Instead, the following section focuses on summarization and evaluation issues that are unique to the single audit.

Evaluating Results of Compliance Tests

For a financial statement audit, SAS No. 107 (AU 312.50) requires the auditor to consider the effects, both individually and in the aggregate, of all known and likely uncorrected misstatements to determine whether they are material to the financial statements. In addition, SAS No. 99 (AU 316.75) requires the auditor to consider whether audit differences may be indicative of possible fraud. To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers. For a single audit, however, SAS No. 74 (AU 801.17) and Paragraphs 10.08 and 10.09 of the GAS/A-133 AICPA Audit Guide require the auditor to consider the effects of noncompliance in relation to each major federal program. In a single audit, the objective of testing transactions for compliance is to express an opinion on whether the organization has complied, in all material respects, with laws, regulations, contracts, and grant agreements, noncompliance with which *could* have a material effect on each major program.

For purposes of assessing compliance in a single audit, Paragraph 10.09 of the GAS/A-133 AICPA Audit Guide defines a material instance of noncompliance 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.” For reporting under *Government Auditing Standards* on compliance with laws and regulations, materiality is measured in terms of the *financial statements*. Material instances of noncompliance for single audits include those instances that could result in the organization having to refund federal monies or make other restitution in an amount that would be material to the particular federal program. Or, an out-of-compliance organization could be denied reimbursement of program expenditures that had already been made.

It can be difficult to assess the materiality of instances of noncompliance because the auditor is not in a position to completely understand some of the implications of the noncompliance that might cause federal officials to discontinue grants, disallow charges, or demand refunds. However, OMB Circular A-133 does not require an opinion that noncompliance *will* have a material effect, but only that noncompliance *could* have a material effect. It will help the auditor to keep in mind that federal agencies have determined that noncompliance with any of the compliance requirements listed in the applicable compliance supplement *could* have a material effect. Even noncompliance with nonmonetary requirements may result in monetary penalties or disallowances if there has been pervasive noncompliance or a pattern of consistent noncompliance.

Paragraph 10.09 of the GAS/A-133 AICPA Audit Guide states that, in reaching a conclusion about whether the effect of noncompliance, “individually or in the aggregate,” is material to a major program, the auditor should consider “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.” SAS No. 74 at AU 801.17 lists the following factors the auditor should consider in evaluating the effect of identified instances of noncompliance on the program:

- a. The frequency of noncompliance identified in the audit.
- b. The adequacy of a primary recipient’s system for monitoring subrecipients and the possible effect on the program of any noncompliance identified by the primary recipient or the auditors of the subrecipients.
- c. Whether any instances of noncompliance identified in the audit resulted in questioned costs . . . and, if they did, whether questioned costs are material to the program.

Projecting Questioned Costs and Expanding Testing

SAS No. 74 (AU 801.18) states that, in evaluating the effect of questioned costs for purposes of forming an opinion on compliance, “the auditor considers the best estimate of total costs questioned for each major federal . . . program (hereafter referred to as *likely questioned costs*), not just the questioned costs specifically identified (hereafter referred to as *known questioned costs*)” and that, when sampling is used, “the auditor should project the amount of known questioned costs identified in the sample to the items in the major . . . program from which the sample was selected.” If likely questioned costs are material to the individual program, the auditor should consider whether additional procedures are necessary.

Generally, the auditor is not required to project questioned costs resulting from a *nonsampling* application to the population from which they were drawn or to perform any additional procedures to determine the effect of any

questioned costs. OMB Circular A-133 does not require that the auditor expand the scope of a sampling application (test additional transactions) to determine the effect of questioned costs determined by the sampling application. However, SAS No. 74 at AU 801.18 requires, for purposes of forming an opinion as to compliance with laws and regulations, that the auditor project the results of any sampling application (but need not report the amount of projected questioned costs). Also, qualitative considerations, such as deliberate instances of noncompliance or other circumstances of specific questioned costs, may cause the auditor to expand the original sample size in order to limit sampling risk or to more precisely estimate the extent of questioned costs, or may cause the auditor to question and report all costs charged to a program.

Considering the Effect of Noncompliance on the Financial Statements

The auditor should also consider the implications of questioned costs for the audit of the financial statements. As part of the audit of the financial statements, the auditor is required to make a preliminary assessment of the risk that the financial statements are materially misstated by errors or fraud. Based on that assessment, the auditor designs and performs appropriate audit procedures with an attitude of professional skepticism and evaluates their results. If conditions or circumstances discovered during the audit differ adversely from the auditor's expectations, the auditor should consider the reason for the difference. SAS No. 99 at AU 316.74 indicates that at or near the completion of fieldwork, "the auditor should evaluate whether the accumulated results of auditing procedures and other observations . . . affect the assessment of the risks of material misstatement due to fraud made earlier in the audit." It is believed the auditor also should consider whether the risk assessment made in planning is still appropriate and whether the conditions or circumstances indicate the likelihood of material misstatement of the financial statements.

According to SAS No. 99 at AU 316.74, the evaluation of accumulated audit results may provide "further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures." Stated differently, if likely questioned costs are material to an individual program, the auditor should consider the need to perform additional or different audit procedures. When the auditor detects instances of noncompliance that are material to a major program, he or she may determine that it is necessary to expand audit procedures to assess the impact of noncompliance on the financial statements. For example, if questioned costs for a particular program are extensive, the grantor agency may decide to question all costs charged to that program. If such costs are subsequently disallowed, the entire amount of funds received under the program may have to be returned to the grantor agency. In this situation, the auditor should consider the potential effects on the financial statements and the need to perform additional procedures. In addition, the auditor should consider the need to record a liability or disclose a contingent liability for questioned costs in accordance with generally accepted accounting principles. (Note that materiality for the single audit compliance opinion is at the major program level, whereas materiality for financial statement adjustment, disclosure, or report modification is at the financial statement level for nonprofit organizations; or opinion unit level for governments. Thus, an instance of noncompliance or a questioned cost that is material to a major program will not automatically be material to the financial statements.)

Government Auditing Standards establish additional requirements related to noncompliance and also establish requirements related to abuse. The Yellow Book, at Paragraph 4.11, requires the auditor to apply additional procedures if evidence of possible violations of provisions of contracts or grant agreements comes to the auditor's attention. If the auditor subsequently concludes that a violation has occurred or is likely to have occurred, the auditor must determine the implications for other aspects of the audit, as well as the effect on the financial statements. Paragraph 4.12 of the Yellow Book states that if auditors become aware of abuse that could be material, they should determine the potential effect on the financial statements. As a result of performing procedures to determine its potential effect, auditors may determine that the abuse represents fraud or illegal acts.

Summarizing Noncompliance Findings

An auditor has to combine, or aggregate, the effect on the organization's major programs, and on the organization's financial statements, of all likely questioned costs to evaluate whether the organization has complied, in all material respects, with the requirements governing the programs. Likely questioned costs, of course, include known questioned costs. To evaluate the combined effect of noncompliance findings, it is necessary to summarize them in one place in the workpapers. A variety of formats could be used to summarize noncompliance findings.

However, the most important point to remember is that the materiality of noncompliance should be evaluated both individually and in combination. It is necessary to combine individually immaterial noncompliance findings to evaluate the materiality of the effect on the individual major programs and on the financial statements taken as a whole.

Prior Years' Unresolved Noncompliance Findings. In addition to considering the effect of current year noncompliance items, the auditor must also consider the effect of findings that were detected in the prior year(s) and still remain unresolved at the completion of the current audit. In addition, unresolved prior year compliance findings should be reported in the current year summary schedule of prior audit findings.

Evaluation of Overall Materiality

After summarizing noncompliance findings, the combined effect needs to be compared to the amount that the auditor considers material to the individual major programs and to the financial statements taken as a whole. In addition to tolerable noncompliance, there are other factors that the auditor should consider when evaluating materiality. These factors include both qualitative considerations and the risk of further undetected noncompliance. While tolerable noncompliance serves as a good starting point, an auditor is not "locked-in" to the preliminary judgment about materiality made at the start of the audit. At that point, materiality is established as a practical necessity in planning. If the auditor concludes that a lower materiality level than initially determined is appropriate, the auditor should reconsider tolerable misstatement and the appropriateness of further audit procedures. If the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that could be material when aggregated with identified misstatements, the auditor should also consider whether the overall audit strategy and audit plan need to be revised.

Consultation on Technical Issues

The review of workpapers, particularly the summarization and evaluation of audit differences, may indicate the need to consult with someone not involved in the engagement on complex technical issues. The fact that consultation has taken place and the resolution of the issue should be documented in the workpapers, but when consultation is necessary and with whom may vary considerably. Some firms designate specialists in particular industries.

Some firms may also designate a particular person to become expert in unusually complex areas. The extent of specialization varies with firm size and individual firm preference. Naturally, the smaller a firm is, the less possibility there is for specialists available for consultation within the firm. On particularly complex matters, outside consultation may be advisable, and, where appropriate, the auditor should consult with the cognizant or oversight agency for audit. SQCS No. 7, *A Firm's System of Quality Control*, (QC 10.72), indicates that a firm should establish policies and procedures designed to provide it with reasonable assurance that consultation takes place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues) and that various other aspects of consultation, including documentation, are sufficient and appropriate.

Documentation of Findings

SAS No. 103, *Audit Documentation*, requires documentation of significant findings or issues, actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached. In addition, SAS No. 107 (AU 312.69) states that the auditor should prepare documentation of the following:

- A summary of uncorrected misstatements, other than trivial ones, related to known and likely misstatements.
- The auditor's conclusion as to whether uncorrected misstatements, individually or in the aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.
- All known and likely misstatements identified by the auditor during the audit, other than trivial ones, that have been corrected by management.

It is believed that the previous matters will generally be documented in the supporting workpapers for the audit area in which the misstatement is detected. In addition, when misstatements that are considered to be significant

findings are discussed with management or others, the auditor should document the discussion in a timely manner and include (a) the items discussed, (b) when and with whom the matters were discussed, and (c) the responses obtained. If any information is obtained either through discussions or from other sources that is contradictory or inconsistent with the auditor's final conclusions, the auditor should document how that information was addressed.

DRAFTING FINANCIAL STATEMENTS AND THE SINGLE AUDIT REPORTS

Drafting the Financial Statements

In many single audit engagements involving small organizations, the auditor drafts or assists with drafting the financial statements. Because single audits are subject to *Government Auditing Standards*, auditors must consider the Yellow Book independence standards when determining whether their participation in drafting the financial statements and notes could impair their independence. The 2007 Yellow Book, at Paragraph 3.28, states that performing these nonaudit services would not be considered to impair the auditor's independence as long as they comply with the Yellow Book's overarching independence principles and certain supplemental safeguards to independence. Question 46 of the GAO's *Answers to Independence Standard Questions* (GAO Q&A) (a link is provided at Gov. Doc. No. 2) addresses auditor involvement with preparing a trial balance and draft financial statements. These activities are considered technical assistance as part of the audit for independence purposes as long as the following requirements are met:

- a. The auditor must be careful not, in essence, to be constructing the records.
- b. The financial statements must be based on a trial balance that was either:
 - (1) Provided by management using appropriate books and records, or
 - (2) Prepared by auditors when their work to prepare the trial balance is technical formatting in nature and uses management's chart of accounts.
- c. The draft financial statements and notes must be reviewed and approved by the management of the audited entity. Management must have adequate knowledge to evaluate and take responsibility for the resulting financial statements and notes.
- d. The management representation letter should acknowledge the auditor's role and management's review, approval, and responsibility for the financial statements and notes.

Similar guidance applies to assistance in drafting the schedule of expenditures of federal awards. However, it is believed that auditors must be especially careful that they are drafting the schedule is based on financial data and program information maintained by the client and that the auditor does not construct the records. The GAS/A-133 AICPA Audit Guide at Paragraph 7.05 notes that the schedule of expenditures of federal awards is different from most other supplementary information included with audited financial statements because it serves as the primary basis for the auditor's major program determination, which is an important aspect of performing a single audit. While OMB Circular A-133 states that the *auditee* is responsible for preparing the schedule, the Circular places responsibility for major program determination on the auditor. Thus, the auditor's determination of appropriate major programs depends on the accuracy and completeness of the information included in the schedule of expenditure of federal awards, and the auditor needs to consider the Yellow Book independence standards as they determine if assistance with drafting the schedule could impair their independence.

Question 46 also points out that the activities described in the paragraph above may be performed by the same engagement personnel that performs the audit as long as the remaining safeguards are met. One such safeguard requires that the audit firm "establish and document an understanding with the audited entity regarding the objectives, scope of work, and product . . . of the nonaudit service" and "that management is responsible for the substantive outcome of the work, and therefore, has a responsibility to be in a position in fact and appearance to make an informed judgment on the results of the nonaudit service."

The organization's management and the governing body should understand that the auditor's involvement in drafting the financial statements or schedule of expenditures of federal awards does not change the character of

the statements or schedule as management's representations. Therefore, this course recommends that the wording discussed in the previous paragraph be included in the engagement letter.

Management must also understand that the auditor's involvement in financial statement preparation may represent a significant deficiency or material weakness in internal control that must be communicated to management and those charged with governance. If the auditor drafts the financial statements because the client lacks sufficient expertise to do so and lacks the skills and competencies necessary to prevent, detect, and correct a material misstatement, this is a control deficiency that is most likely a significant deficiency or material weakness.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. The detailed review of the current workpaper file for each financial statement component and for each financial program would include which of the following steps related to reviewing the supporting schedules?
 - a. Amounts agree with the amounts in the working trial balance and have been traced to the general ledger.
 - b. Any information on a workpaper for a financial statement element that is relevant to another element has been properly considered and cross-referenced.
 - c. Any relevant information in the permanent file or other general files has been incorporated or cross-referenced.
 - d. Any significant audit findings or issues have been adequately addressed and documented.
7. What is one item that both SAS No. 103 and the *Government Auditing Standards* require to be included in an audit documentation?
 - a. Supervisory review.
 - b. Review notes.
 - c. A quality control checklist.
 - d. Who reviewed specific documentation.
8. An auditor must perform which of the following tasks when projecting questioned costs and expanding testing?
 - a. Project questioned costs resulting from a nonsampling application to the population from which they were drawn.
 - b. Extend the sampling application scope to determine the effect of questioned costs determined by the sampling application.
 - c. Project the amount of known questioned costs identified in the sample to the items in the major program from which the sample was selected.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. The detailed review of the current workpaper file for each financial statement component and for each financial program would include which of the following steps related to reviewing the supporting schedules? **(Page 278)**
 - a. **Amounts agree with the amounts in the working trial balance and have been traced to the general ledger. [This answer is correct. For each financial statement component within each opinion unit, fund type, or fund, an auditor should review the supporting schedules to assure that amounts agree with the amounts in the working trial balance and have been traced to the general ledger.]**
 - b. Any information on a workpaper for a financial statement element that is relevant to another element has been properly considered and cross-referenced. [This answer is incorrect. When reviewing the general section of the file and the workpapers as a whole an auditor should assure that any information on a workpaper for a financial statement element that is relevant to another element has been properly considered and cross-referenced.]
 - c. Any relevant information in the permanent file or other general files has been incorporated or cross-referenced. [This answer is incorrect. For the general section of the file and the workpapers as a whole, an auditor should assure that any relevant information in the permanent file or other general files has been incorporated or cross-referenced.]
 - d. Any significant audit findings or issues have been adequately addressed and documented. [This answer is incorrect. This is a step used in the detailed review of the general section of the file and the workpapers as a whole.]
7. What is one item that both SAS No. 103 and the *Government Auditing Standards* require to be included in an audit documentation? **(Page 279)**
 - a. **Supervisory review. [This answer is correct. Both SAS No. 103 and *Government Auditing Standards* require the audit documentation (workpapers) to include evidence of supervisory review.]**
 - b. Review notes. [This answer is incorrect. Any review notes or comments from the earlier stages of review should be satisfactorily resolved by the completion of the supervisory review. The particular practices adopted for documenting and clearing review notes are a matter of individual firm preferences in engagement administration. Once the audit has been completed, all review points and notes should be *removed* from the workpapers, as they do not constitute audit evidence.]
 - c. A quality control checklist. [This answer is incorrect. Most firms use some form of checklist to serve as a reminder of important engagement completion matters and to document completion of a review of the workpapers. However, these checklists, although not required, may be helpful in preparing audit reports and supporting workpapers that comply with the requirements of OMB Circular A-133.]
 - d. Who reviewed specific documentation. [This answer is incorrect. Only SAS No. 103 requires that the workpapers indicate who reviewed specific audit documentation and the date of the review. Auditors are not required to indicate their review on each specific workpaper. However, the documentation should clearly indicate who reviewed specified elements of the audit work and when.]
8. An auditor must perform which of the following tasks when projecting questioned costs and expanding testing. **(Page 281)**
 - a. Project questioned costs resulting from a nonsampling application to the population from which they were drawn. [This answer is incorrect. Generally, the auditor is not required to project questioned costs resulting from a nonsampling application to the population from which they were drawn or to perform any additional procedures to determine the effect of any questioned costs.]

- b. Extend the sampling application scope to determine the effect of questioned costs determined by the sampling application. [This answer is incorrect. OMB Circular A-133 does not require that the auditor expand the scope of a sampling application (test additional transactions) to determine the effect of questioned costs determined by the sampling application.]
- c. **Project the amount of known questioned costs identified in the sample to the items in the major program from which the sample was selected.** [This answer is correct. SAS No. 74 (AU 801.18) states that, in evaluating the effect of questioned costs for purposes of forming an opinion on compliance, “the auditor considers the best estimate of total costs questioned for each major federal . . . program (hereafter referred to as likely questioned costs), not just the questioned costs specifically identified (hereafter referred to as known questioned costs)” and that, when sampling is used, “the auditor should project the amount of known questioned costs identified in the sample to the items in the major . . . program from which the sample was selected.” If likely questioned costs are material to the individual program, the auditor should consider whether additional procedures are necessary.]

DATA COLLECTION FORM

To streamline the distribution of audit reports and improve the government-wide collection and analysis of single audit results, Section 320 of OMB Circular A-133 provides for a form, referred to as the data collection form, to be prepared at the completion of each audit and submitted to the federal clearinghouse designated by the OMB. The form provides key information about the non-federal entity, the federal awards it administers, whether the audit was completed in accordance with OMB Circular A-133, and the audit results. It serves as the basis for developing a government-wide database on covered federal awards administered by non-federal entities. The database of information on data collection forms is available online at the Federal Audit Clearinghouse website noted at <http://harvester.census.gov/sac>. Federal agencies use the data to support ad hoc reporting, perform additional analysis, and support policy decisions. The data collection form and the single audit reporting package are submitted together to the Federal Audit Clearinghouse. (The single audit reporting package includes the entity's financial statements, schedule of expenditures of federal awards, the auditor's reports, and other items.)

Section 320 of OMB Circular A-133 requires that the auditor prepare applicable sections of the form. The OMB believes that the auditor's association with the data collection form adds value to its usefulness, reduces the need for federal awarding agencies and pass-through entities to perform unnecessary verification procedures, improves the accuracy of the government wide database, streamlines the single audit report submission process, and reduces the burden on auditees. Under the new electronic submission process, a certifying official for the audit firm is required to electronically sign a statement identifying the reporting package as 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 that required by OMB Circular A-133. Although the certifying official performs the electronic certification, it is the audit firm's name that is reported in the electronic data collection form. Due to the coordination necessary to complete the electronic single audit submission, it will probably be completed and submitted to the Federal Audit Clearinghouse subsequent to the date of the auditor's reports. However, the auditor is protected against subsequent event responsibility for the latter date due to a clause in the auditor's statement in the data collection form indicating that no additional procedures have been performed since the date of the auditor's reports.

2008 Data Collection Form

In September 2008, the OMB released a new version of the data collection form and revised the submission processes for the data collection form and the single audit reporting package. Beginning with audits of fiscal periods ending in 2008, a revised data collection form and the reporting package must be submitted electronically to the Federal Audit Clearinghouse using the Internet Data Entry System (IDES). For fiscal years ending before 2008, electronic filing of the applicable data collection form was optional and the rest of the related single audit reporting package had to be submitted on paper or in a CD-ROM. It should be noted that revisions to the data collection form and the submission process are applicable for specific reporting periods and do not supersede previous years' reporting requirements. In other words, the 2008 data collection form should not be used for audits of fiscal periods ending before January 1, 2008. The Federal Audit Clearinghouse still provides detailed filing instructions and forms for fiscal periods ending as far back as 1997. Auditors can find these instructions and forms at the clearinghouse website at <http://harvester.census.gov/fac/collect/formoptions.html>.

The 2008 data collection form is required to be used for audits of fiscal periods ending in 2008, 2009, and 2010. Both the auditor and auditee have responsibilities for completing portions of the data collection form (Form SF-SAC) in the IDES before it is submitted with the single audit reporting package. The reporting package must be contained in a single unsecured PDF file that is uploaded to the IDES. That is, it cannot have password protection for opening, editing, printing, etc. Only one copy of the reporting package should be submitted electronically through the IDES, and anything other than a completed data collection form and reporting package will not be accepted. After the data collection form has been completed and the PDF copy of the reporting package is successfully uploaded, both the auditee and the auditor certify the submission electronically by using a unique signature code provided by the IDES and sent to each of them by email. A confirmation email is generated after submission of the reports, and auditors or their clients can check the status of a submission at <http://harvester.census.gov/fac/dissemin/disclaim.html>.

The OMB and Federal Audit Clearinghouse made other changes and enhancements when the 2008 data collection form and new electronic filing requirements were released:

- *Revisions to Internal Control Terminology and Definitions.* OMB Circular A-133 requires auditors to report on internal control over compliance related to major federal programs. The 2008 data collection form reflects the 2007 revisions to Circular A-133 which require auditors to use terminology consistent with SAS No. 112 (AU 325A) when reporting on internal control over compliance related to major federal award programs. Control deficiencies in internal control over compliance are reported in Part II—items 3 and 4, and Part III—items 4, 5, and 10(a) of the data collection form.
- *Warnings about Major Program Identification.* Misidentifying major programs is a common audit deficiency. With respect to the data collection form, this can occur when the incorrect box in the form is marked indicating a major program when in fact the program is not major. The Federal Audit Clearinghouse made an enhancement in IDES to help preparers avoid this error. When the 2008 data collection form is completed, a pop-up message appears at certain points (for example in part III, item 9g) that states, “Caution! Programs indicated as major must agree with programs identified as major in the summary of auditor’s results and actually tested as major by the auditor.”
- *Form SF-SAC Worksheet.* The Clearinghouse also provides a “Form SF-SAC Worksheet & Single Audit Component Checklist” that can be downloaded and used to assist in preparing the data collection form. The worksheet prominently indicates that the form can only be submitted electronically. The “Single Audit Component Checklist” portion of the form contains the information that will be required in the first step of uploading the single audit reporting package.
- *Online Certification.* Beginning with audits for fiscal periods ending in 2008, the data collection form and single audit reporting package are both submitted electronically through the IDES. The auditor and the auditee’s certifying official also certify the submission within the IDES.
- *Upload Federal Program Data.* The federal program data required on Page 3 of the data collection form can be uploaded from a spreadsheet into the IDES.
- *Secondary Auditor Information.* Although it is not required, the IDES allows the principal auditor to enter contact information for a second audit organization.

American Recovery and Reinvestment Act. The American Recovery and Reinvestment Act of 2009 (Recovery Act) requires federal award recipients to separately report expenditures of Recovery Act funds on the schedule of expenditures of federal awards and the data collection form. This requirement relates not only to new programs but also to Recovery Act funds awarded for existing programs. New part 176 of CFR Title 2, “Award Terms for Assistance Agreements that Include Funds under the American Recovery and Reinvestment Act of 2009, Public Law 111-5” [2 CFR part 176.210(b)], states:

This shall be accomplished by identifying expenditures for Federal awards made under the Recovery Act separately on the SEFA, and as separate rows under Item 9 of Part III on the SF-SAC by CFDA number, and inclusion of the prefix “ARRA-” in identifying the name of the Federal program on the SEFA and as the first characters in Item 9d of Part III on the SF-SAC.

This course recommends that auditors closely monitor the Federal Audit Clearinghouse website, <http://harvester.census.gov/fac>, for updated information on the data collection form.

Public Availability of Single Audit Reports. The Recovery Act requires the federal audit clearinghouse to make publicly available on the Internet all single audit reports filed with it for fiscal years ending September 30, 2009, and later. This requirement makes it important to ensure that no confidential information (such as names, social security numbers, etc.) is included in the information filed with the Federal Audit Clearinghouse.

Contents of the Data Collection Form

A summary of the contents of the form as described in Section 320 of OMB Circular A-133 follows:

- a. 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).
- b. Where applicable, a statement that significant deficiencies in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.
- c. A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee.
- d. Where applicable, a statement that significant deficiencies in internal control over major programs were disclosed by the audit and whether any such deficiencies were material weaknesses.
- e. The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
- f. A list of the federal awarding agencies and pass-through entities which will receive a copy of the reporting package as described at Section 320(d)(2) of Circular A-133.
- g. A yes or no statement as to whether the auditee qualified as a low-risk auditee under Section 530 of OMB Circular A-133.
- h. The dollar threshold used to distinguish between Type A and Type B programs as defined at Section 520(b) of OMB Circular A-133.
- i. The *Catalog of Federal Domestic Assistance* (CFDA) number for each federal program, as applicable.
- j. 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.
- k. The amount of expenditures in the schedule of expenditures of federal awards associated with each federal program.
- l. For each federal program, an indication as to whether there are audit findings in each of the following types of compliance requirements and the total amount of any questioned costs.
 - (1) Activities allowed or unallowed
 - (2) Allowable costs/cost principles
 - (3) Cash management
 - (4) Davis-Bacon Act
 - (5) Eligibility
 - (6) Equipment and real property management
 - (7) Matching, level of effort, earmarking
 - (8) Period of availability of federal funds
 - (9) Procurement and suspension and debarment
 - (10) Program income
 - (11) Real property acquisition and relocation assistance
 - (12) Reporting
 - (13) Subrecipient monitoring
 - (14) Special tests and provisions

m. Auditee Name

Employer Identification Number(s)
 Name and Title of Certifying Official
 Telephone Number
 Signature
 Date

n. Auditor Name

Name and Title of Contact Person
 Auditor Address
 Auditor Telephone Number

o. Whether the auditee has a cognizant or oversight agency for audit.

p. The name of the cognizant or oversight agency for audit determined in accordance with Sections 400(a) and 400(b) of Circular A-133, respectively.

Submission of Data Collection Form and Single Audit Reporting Package

The 2008 data collection form must be submitted electronically to the Federal Audit Clearinghouse using the Internet Data Entry System (IDES). The IDES was created to allow users to (a) enter data into the online data collection form, (b) check for errors, (c) receive feedback from the IDES, and make corrections, (d) upload the single audit reporting package, and (e) certify the submission. Upon completion and certification, data collection form and single audit reporting package are submitted electronically to the Federal Audit Clearinghouse. The edit check feature is designed to detect errors before forms are submitted.

Accessing the IDES. To complete the 2008 data collection form and submit the single audit reporting package, auditees and auditors should access the Federal Audit Clearinghouse's website at <http://harvester.census.gov/fac/collect/formoptions.html> and select "Enter Form SF-SAC Data Online." The IDES can also be accessed directly at <http://harvester.census.gov/fac/collect/ddeindex.html>.

At the IDES introductory page, users must select one of the following options:

- "Enter A New Form."
- "Update A Form" (to update a form from a previous session).
- "FAC Home Page" (to return to the main Federal Audit Clearinghouse website).
- "Retrieve Lost Password" (to enter a question and answer for Report ID and password retrieval).

Entering a New Form. After clicking on the "Enter a New Form" button, users should:

- Enter the entity's Employer Identification Number (EIN).
- Enter the fiscal year ending date for the submission.
- Enter and confirm a Report ID password.
- Select a question to answer for password retrieval and enter the answer to the question. (The IDES introductory page has a password retrieval function that can be used in case of a lost password or Report ID.)
- Click "Yes" to start. A confirmation page window will provide a unique report identification number (Report ID) and a record of the user's password.

- Print the Report ID and password confirmation page and click “continue.”
- Enter the email addresses for the auditor and the auditee’s official(s) that will certify the submission. These email addresses will be used in the certifying step and for notifications if a new form is created or a password is changed.

After the preliminary information has been input, the user will be taken to the “IDES Main Menu” page, which contains functions for completing the online data collection form (Form SF-SAC), uploading the single audit reporting package, performing account maintenance, accessing instructions, certifying the data collection form, submitting the data collection form and the single audit reporting package (collectively referred to as the “single audit package” in the IDES), and exiting the IDES. Other features in the IDES allow the user to:

- Resume a session. (The IDES allows the user to exit and re-enter an online form as many times as needed to complete it. The user can also unlock a finalized form to make changes.)
- Upload Page 3, Item 9 (federal program data), from a spreadsheet. (This method is optional if there are fewer than 80 lines of programs to be reported.)
- Upload Page 4 for multiple EINs from a spreadsheet. (This method is optional if there are fewer than 80 EINs to be reported.)
- Upload Page 4 for multiple DUNS from a spreadsheet. (This method is optional if there are fewer than 80 DUNS to be reported.)
- Enter secondary auditors’ contact information in Page 5. (Reporting secondary auditors is optional.)
- Perform a validation check on the data and print error lists.
- Print forms before they are submitted.
- File a revised submission.

The Federal Audit Clearinghouse has provided detailed instructions for the entire submission process in its “IDES 2008–2010 Instructions,” which can be downloaded from the IDES website at http://harvester.census.gov/fac/collect08/main_instruct.pdf.

Avoiding Reporting Problems

Previous editions of this material discussed the errors commonly made in preparing the data collection form and in submitting the required reports to the Federal Audit Clearinghouse. Many of these errors related to the submission process itself, such as failing to sign the data collection form and submitting incomplete reporting packages. It is believed that the mandatory online submission process and the edit checks that have been built into the IDES are significant improvements and should eliminate many of the submission problems previously reported by the Clearinghouse. Additionally, the “Form SF-SAC Worksheet & Single Audit Component Checklist,” provided by the Federal Audit Clearinghouse at <http://harvester.census.gov/fac/collect08/2008Worksheet.pdf>, is a useful tool for assembling and checking the information that is required for the data collection form.

While the enhancements in the IDES should streamline the submission process, it is believed worthwhile to emphasize the importance of reviewing all of the data, reports, and other information that has been input to the IDES before it is submitted. Past editions of the AICPA Audit Risk Alert, *Government Auditing Standards and Circular A-133 Audits*, have pointed out that federal OIGs may use data collection forms or the clearinghouse database to identify potential issues with single audits. This review process could highlight issues that would require OIG follow-up with the auditor, or could even result in an OIG quality control review of the audit in question. It is believed auditors should be aware of the “red flags” identified in the AICPA audit risk alert. Examples include the following:

- Checking the wrong box in Part II could indicate to a reviewer that the preparer did not understand the nature of the auditor’s report

- Errors in completing Part III, Items 1 through 8, might lead a reviewer to conclude the auditor did not understand one or more of the following concepts: low risk auditee, type of report issued, or what belongs on the summary of prior audit findings.
- Failing to complete Part III, Item 9 properly could lead a reviewer to question whether the auditor understands the concept of “major programs,” whether the auditor audited the correct major programs, and/or whether the auditor understands the nature of the findings reported.

It is important for auditors to carefully review the data collection form before it is submitted. The AICPA Audit Risk Alert, *Government Auditing Standards and Circular A-133 Audits—2007*, provided the following suggestions for reviewing the form:

- **Part II: *Financial Statements*.** Part II refers to the report on the financial statements and the report issued under *Government Auditing Standards*, not the report on internal control and compliance related to federal programs. Simultaneously reading the auditor’s final reports and the form could help make sure this section is prepared using the final versions of the reports and that the form is consistent with those reports.
- **Part III: *Federal Programs*.** It is recommended that the reviewer read the instructions for Part III of the data collection form before reviewing this part. Simultaneously reviewing the final OMB Circular A-133 reports and the data collection form could help ensure that the entries on the form are consistent with the results of the audit. Other tips for reviewing various items in this part include—
 - Item 7: This item should be answered “no” if the summary schedule of prior audit findings indicates there were no prior audit findings.
 - Item 8: All agencies affected by a finding should be included. Finally, it is important that the findings include all of the required elements.
 - Item 9: The programs should be listed in the same level of detail as in the schedule of expenditures of federal awards. For example, if the schedule lists ten Department of Health and Human Services (DHHS) awards within one or more CFDA numbers, Item 9 should also list ten DHHS awards.
 - Item 9: The reviewer should verify that Columns C, F, and G have been completed correctly.
 - Item 10, Column A: This item should seldom include response P (“Other”). (Some preparers enter “P” instead of taking the time to properly match a finding to the appropriate compliance requirement. If “P” is provided as a response, extra attention may be needed to assure that the response is correct.)

Resubmission

Resubmissions for Fiscal Years Ending in 2008 and Later. One of the enhancements made in IDES by the Federal Audit Clearinghouse when the new electronic filing requirements were released in 2008 is a function that allows revisions of the data collection form and/or the single audit reporting package to be submitted online to the Federal Audit Clearinghouse. To make a revision, the auditor and auditee should log in to the IDES system using the entity’s Report ID and applicable passwords, and select the “File a Revised Submission” option. Detailed instructions for resubmissions are included in the Federal Audit Clearinghouse’s document, “IDES 2008–2010 Instructions.” The resubmission must be certified by both the auditor and the auditee. No paper copies are required to be filed with the Federal Audit Clearinghouse. There are different procedures for making changes to the data collection form after it is submitted depending on whether or not the form was originally filed using the IDES. Detailed instructions on making changes to data collection forms in either case are provided at http://harvester.census.gov/sac/collect/revisions_Main.html. Question 15 in the “2002–2007 FAQ’s” on the Federal Audit Clearinghouse website also provides useful information about submitting revisions. The FAQ can be viewed at <http://harvester.census.gov/fac/FAQ.htm>.

When resubmitting data collection forms to correct errors for fiscal years ending prior to 2008, it is only necessary to correct the problem noted. Common problems noted by the Federal Audit Clearinghouse when forms were resubmitted include:

- Failing to involve the auditor in resubmission.
- Failing to write "Revision" at the top of page 1 of the data collection form, and to fill out page 1 completely.
- Failing to sign and date the revised form (by both auditor and auditee).
- Failing to re-total column (e) of Part III, item 9, the total federal awards expended, when necessary.

In other situations where reporting packages are revised, it is recommended that the auditee or auditor contact the Federal Audit Clearinghouse processing center at (888) 222-9907.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. The Federal Audit Clearinghouse requires the recipient to submit a single audit reporting package. Which of the following items is **not** a required part of the package?
 - a. The entity's financial statements.
 - b. The auditor's reports.
 - c. The names and addresses of the members of the boards of directory.
 - d. The schedule of expenditures of federal awards.
10. The OMB has released a new version of the Single Audit Data Collection Form and revised the submission process. Under this new process, the Federal Audit Clearinghouse requires that the form be submitted in which of the following ways?
 - a. U.S. mail.
 - b. Fax.
 - c. Electronic submission.
 - d. Fed Ex.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. The Federal Audit Clearinghouse requires the recipient to submit a single audit reporting package. Which of the following items is **not** a required part of the package? **(Page 290)**
- a. The entity's financial statements. [This answer is incorrect. The entity's financial statements are just one of the required items to be included in the single audit reporting package.]
 - b. The auditor's reports. [This answer is incorrect. The auditor's reports must be included in the single audit reporting package.]
 - c. **The names and addresses of the members of the boards of directory. [This answer is correct. The names and addresses of the members of the boards of directory is not a part of the single audit reporting package.]**
 - d. The schedule of expenditures of federal awards. [This answer is incorrect. The schedule of expenditures of federal awards must be included in the single audit reporting package.]
10. The OMB has released a new version of the Single Audit Data Collection Form and revised the submission process. Under this new process, the Federal Audit Clearinghouse requires that the form be submitted in which of the following ways? **(Page 290)**
- a. U.S. mail. [This answer is incorrect. The Standards have changed and now requires a different delivery method.]
 - b. Fax. [This answer is incorrect. According the new Standard, forms cannot be submitted via fax.]
 - c. **Electronic submission. [This answer is correct. September 2008, the OMB released a new version of the data collection form and revised the submission processes for the data collection form and the single audit reporting package. Beginning with audits of fiscal periods ending in 2008, a revised data collection form and the reporting package must be submitted electronically to the Federal Audit Clearinghouse using the Internet Data Entry System (IDES).]**
 - d. Fed Ex. [This answer is incorrect. The Standards have changed and do not permit submission via Fed Ex.]

EXIT CONFERENCE AND CLIENT COMMUNICATIONS

Upon the completion of fieldwork, the auditor typically holds a closing or exit conference; such a meeting is sometimes required in the engagement contract. Those attending the conference are normally key members of management and audit staff. In the case of an organization with decentralized operations (e.g., a university), the federal government encourages preliminary meetings with department heads and operating personnel having direct responsibility for administering the specific programs. In addition, the cognizant or oversight agency for audit may attend the exit conference. (Many grantor agencies require that they be notified of the dates of conferences and have the opportunity to send a representative.)

The exit conference has several important purposes that relate to the auditor's professional requirements. Complex or unusual accounting principles or other matters in the financial statements, including any unresolved issues of presentation or disclosure should be discussed. This is necessary so that the client can take responsibility for the financial statements. Another important purpose of the exit conference is to review draft copies of the auditor's reports, including the reports on compliance and internal controls. Written communication of internal control deficiencies is required by professional standards, so any modifications of the auditor's reports would be emphasized in the meeting. Also, the Yellow Book requires the auditor and, as noted in Paragraph 2.49 of the GAS/A-133 AICPA Audit Guide, it also provides the client with an advance opportunity to discuss whether planned corrective actions adequately address the auditor's recommendations and to initiate corrective action without waiting for the final audit report. Also, the Yellow Book requires the auditor to obtain the client's views concerning the auditor's findings, conclusions, and recommendations, as well as the client's planned corrective actions. The exit conference facilitates this requirement and, as noted in Paragraph 2.49 of the GAS/A-133 AICPA Audit Guide, it also provides the client with an advance opportunity to discuss whether planned corrective actions adequately address the auditor's recommendations and to initiate corrective action without waiting for the final audit report. Also, the Yellow Book requires the auditor to include the views of responsible client officials in the reports, including management's agreement or disagreement with the auditor's findings and conclusions.

Cognizant or Oversight Agency for Audit Participation in Exit Conference

A representative from the cognizant or oversight agency for audit may (but generally does not) attend the exit conference. This can be in the best interest of both the auditor and the organization. By having the cognizant or oversight agency for audit attend the exit conference, both management and the cognizant or oversight agency for audit have the opportunity to discuss noncompliance findings and possible grantor actions that may result. This will allow the auditor to better determine the effect and materiality of noncompliance findings before issuing his or her reports. In addition, having the cognizant or oversight agency for audit attend the exit conference allows the agency and management to discuss possible corrective actions. This gives the organization the opportunity to initiate corrective action in a timely manner, without waiting for the auditor's final report.

The auditor should note that some grantor agencies *require* the auditor to hold an exit conference with the organization's personnel. In some cases, a written report on the exit conference is specifically required. The content of exit conference reports is usually factual (e.g., date, persons attending, location, subjects discussed, etc.). Thus, these reports do not usually present any technical reporting difficulties.

Additional Matters to Be Communicated

The auditor should discuss all matters he or she considers significant. For example, the auditor should discuss any problems identified during the audit, such as deficiencies in internal control, violations of budget or grant requirements, and errors or fraud that are not required to be communicated in writing. Other suggestions for improvement might also be discussed, as well as matters such as potential management letter comments, the final audit fee, other advisory services the accounting firm might suggest, and final arrangements for report distribution. The auditor should ensure the communication requirements of the following SASs have been met:

- SAS No. 54 (AU 317), *Illegal Acts by Clients*.
- SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*.
- SAS No. 112 (AU 325A), *Communicating Internal Control Related Matters Identified in an Audit*.

- SAS No. 114 (AU 380), *The Auditor's Communication with Those Charged with Governance*.
- SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*

PPC's *Guide to Audits of Local Governments* and *PPC's Guide to Audits of Nonprofit Organizations* include detailed discussions about the requirements of these SASs.

The 2007 Yellow Book requires the auditor to communicate, in writing, certain information to management, those charged with governance, and individuals contracting for or requesting the audit during the planning stage of an engagement.

Communicating Internal Control Related Matters

Both SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*, and SAS No. 112 (AU 325A), of the same name, establish requirements for auditors to communicate certain control deficiencies they have identified during the audit. SAS Nos. 115 and 112 require the auditor to evaluate identified control deficiencies and to communicate significant deficiencies and material weaknesses identified during the audit in writing to management and those charged with governance. The communication is best made by the report release date but, in any case, should be made within 60 days of that date.

Government Auditing Standards requires the report on internal control to disclose significant deficiencies and material weaknesses in internal controls over financial reporting based on the audit of the financial statements. Accordingly, at Paragraphs 5.11 and 5.13, the Yellow Book states that the auditor should report all internal control deficiencies that are significant deficiencies, and all significant deficiencies (or combinations of significant deficiencies) that are considered to be material weaknesses. The Yellow Book adopts the internal control terminology and definitions of SAS No. 112 (AU 325A), therefore the internal control deficiencies that are required to be reported under *Government Auditing Standards* are the same as those that are required to be communicated according to SAS No. 112 (AU 325A). The Yellow Book also adopts the internal control communication requirements under SAS No. 112 (AU 325A); therefore, audits performed under *Government Auditing Standards* will meet the internal control communication requirements of SAS No. 112 (AU 325A). (Interim guidance from the GAO on implementing SAS No. 115 in a Yellow Book audit.)

To determine which control deficiencies to report, the auditor must first identify control deficiencies, and then evaluate them to determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses.

Evaluating Control Deficiencies in a Single Audit. In a single audit, the significance of a control deficiency depends on the potential for noncompliance. When evaluating whether control deficiencies are significant deficiencies or material weaknesses, the auditor considers both the likelihood and magnitude of actual or potential noncompliance.

Communicating With Those Charged With Governance

SAS No. 114, *The Auditor's Communication with Those Charged with Governance*, establishes requirements and provides guidance on the auditor's communication with the individuals responsible for an entity's governance. Under SAS No. 114, communication with those charged with governance has the following three primary purposes:

- to clearly communicate an overview of the audit scope, the timing of the audit, and the auditor's responsibilities;
- to provide timely observations arising from the audit that are relevant to oversight of the financial reporting process; and
- to obtain relevant audit-related information from those charged with governance.

Documentation of the Exit Conference

Following the exit conference, the auditor should be sure to document details of the conference in the audit workpapers. Documentation should include the names and titles of individuals attending the conference, details of matters discussed in the conference, and comments made by officials of the organization. In addition, the auditor should document the details of any separate discussions held with the cognizant agency.

WORKPAPER FINALIZATION, ACCESS, AND RETENTION

After the auditor issues his or her report to the client, professional standards require that the workpapers be completed on a timely basis. Furthermore, workpapers should also be retained for a specified period of time.

Documenting Revisions after the Date of the Auditor's Report

GAAS includes requirements for (a) assembling and completing the workpapers at the conclusion of the audit and (b) making revisions to the documentation after the date of the auditor's report. These requirements are centered on the following key dates:

- The audit report date.
- The report release date.
- The documentation completion date.

Audit Report Date. The audit report date represents the date that the auditor has obtained sufficient appropriate evidence to support his or her opinions on the financial statements and on compliance. Typically, this includes evidence that—

- The audit work has been reviewed.
- The financial statements, including disclosures, have been prepared.
- Management has taken responsibility for the financial statements.

The auditor's report should thus be dated using a date that signifies the completion of workpaper review, the preparation of the financial statements, and the receipt of management's representation that they are responsible for the financial statements (ordinarily in the management representation letter).

According to AICPA Technical Practice Aid, *The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report* (TIS 9100.06-.07), the auditor does not need to be in physical receipt of the management representation letter on the date of the auditor's report, but should have the signed letter in hand prior to releasing the auditor's report. At the date of the report, management has to have reviewed the final representation letter and, at a minimum, orally confirmed that they will sign it without exception on or before the date of the representations.

Report Release Date. The report release date is the date that the auditor gives the client permission to use the auditor's reports. For most audits, this will be the date that the auditor delivers the reports to the client. SAS No. 103 requires the auditor to document the report release date in the workpapers. In most cases, the report release date should be close to the date of the auditor's report.

Documentation Completion Date. SAS No. 103 indicates that the final assembly and completion of the audit file should occur within 60 days of the report release date. SAS No. 103 refers to this date as the *documentation completion date*. After this date, the auditor must not delete or discard any documentation prior to the end of the required five-year retention period. Auditors may adopt documentation completion periods that are shorter than 60 days, either on an engagement-by-engagement basis, or as part of the firm's policy of quality control. In addition, the auditor should consider whether there are regulatory or state requirements that require a shorter documenta-

tion completion period. The impact of these file completion requirements should be carefully considered by the auditor when scheduling and planning engagement time and resources. In many cases, auditors cannot wait until the end of busy season to finalize the audit files of engagements completed earlier in the year. It is recommended that auditors complete workpapers on a timely basis as the audit progresses to minimize the impact of finalizing the audit files.

SAS No. 103 (AU 339.28) states that at any time prior to the documentation completion date, the auditor is permitted to make changes to the workpapers to—

- Finalize the documentation and assemble the evidence that was obtained, discussed, and agreed among the audit team prior to the date of the auditor's report, including discarding to-do lists and superseded drafts, correcting typographical errors, and changing notes that reflect incomplete or preliminary thinking.
- Insert information that was received after the date of the auditor's report such as replacing faxed copies of confirmations with originals.
- Perform routine file assembly procedures that might include sorting, cross-referencing, collating, and deleting or discarding superseded documentation.
- Sign off on file completion checklists prior to completing and archiving the workpapers.

The examples provided in this paragraph emphasize that the auditor should not be adding or changing information after the date of the auditor's report that was necessary to support the opinion on the financial statements. That is, the auditor should not make changes after the report date that would have impacted the documentation of the work performed, the evidence obtained, the conclusions reached, or the review that was conducted prior to that date.

There is no authoritative guidance on how the 60-day requirement applies when a single audit is performed after the financial statement audit has been completed. However, paragraph .113 of the AICPA audit risk alert for single audits indicates that some people are interpreting the requirement to mean that single audit documentation has to be assembled within 60 days of delivery of the OMB Circular A-133 report.

Workpaper Retention

Auditors should establish policies and procedures regarding the retention of workpapers. These policies should be for a time frame that meets the needs of the auditor's practice and considers any regulatory or legal requirements regarding document retention. SAS No. 103 specifically indicates that this period should not be shorter than five years from the report release date. Section 515 of OMB Circular A-133 states that the auditor must keep single audit workpapers and reports for at least three years after the date of issuance of the auditor's report(s) to the auditee. Therefore, audit documentation for single audits should also be retained for at least *five years* from the report release date (since SAS No. 103 establishes a longer retention period than OMB Circular A-133 does). In addition, Section 515 states that the auditor should maintain the audit documentation for a longer period if the auditor is notified in writing by the cognizant or oversight agency for audit, or pass-through entity to extend the retention period. If the auditor is aware that an audit finding is being contested by any of the parties involved, the auditor must seek guidance from the appropriate parties before the related workpapers or reports are destroyed. Auditors should also be aware that various states have enacted or are considering legislation that addresses the retention of audit workpapers and may require a longer retention period.

The auditor must allow GAO, cognizant or oversight agency for audit officials or their designees, or a federal agency providing direct or indirect funding full and timely access to the workpapers. This requirement and other GAO requirements generally increase the extent of workpaper documentation necessary in a single audit.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Select the best statement below concerning exit conferences.
 - a. An oversight agency representative must attend the exit conference.
 - b. Certain grantor agencies require auditors to hold an exit conference.
 - c. Certain grantor agencies require auditors to provide a written report on all exit conferences.
12. SAS No. 112 establishes which of the following requirements?
 - a. How auditors should handle clients who perform illegal acts.
 - b. How auditors consider fraud in financial statement audits.
 - c. How an auditor communicates internal control related matters identified in an audit.
 - d. How an auditor communicates with clients charged with governance.
13. Which of the following is considered the audit report release date?
 - a. The date the auditor gives the client permission to use the auditor's reports.
 - b. The date the auditor has received sufficient evidence to support his or her opinions on the financial statements.
 - c. The date of the final assembly of the audit file.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. Select the best statement below concerning exit conferences. **(Page 299)**

- a. An oversight agency representative must attend the exit conference. [This answer is incorrect. a representative from the cognizant or oversight agency for audit may (but generally does not) attend the exit conference.]
- b. Certain grantor agencies require auditors to hold an exit conference. [This answer is correct. In certain situations, grantor agencies *require* the auditor to hold an exit conference with the organization's personnel.]**
- c. Certain grantor agencies require auditors to provide a written report on all exit conferences. [This answer is incorrect. Only in some cases is a written report on an exit conference specifically required. The content of exit conference reports is usually factual (e.g., date, persons attending, location, subjects discussed, etc.). Thus, these reports do not usually present any technical reporting difficulties.]

12. SAS No. 112 establishes which of the following requirements? **(Page 300)**

- a. How auditors should handle clients who perform illegal acts. [This answer is incorrect. SAS No. 54 establishes requirements regarding illegal acts by clients.]
- b. How auditors consider fraud in financial statement audits. [This answer is incorrect. SAS No. 99 establishes requirements regarding consideration of fraud in a financial statement audit.]
- c. How an auditor communicates internal control related matters identified in an audit. [This answer is correct. Both SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AU 325), and SAS No. 112 (AU 325A), of the same name, establish requirements for auditors to communicate certain control deficiencies they have identified during the audit. SAS No. 115 and SAS No. 112 require the auditor to evaluate identified control deficiencies and to communicate significant deficiencies and material weaknesses identified during the audit in writing to management and those charged with governance.]**
- d. How an auditor communicates with clients charged with governance. [This answer is incorrect. SAS No. 114 specifically establishes how the auditors communicate with those charged with governance.]

13. Which of the following is considered the audit report release date? **(Page 301)**

- a. The date the auditor gives the client permission to use the auditor's reports. [This answer is correct. The report release date is the date that the auditor gives the client permission to use the auditor's reports. For most audits, this will be the date that the auditor delivers the reports to the client.]**
- b. The date the auditor has received sufficient evidence to support his or her opinions on the financial statements. [This answer is incorrect. The audit report date represents the date that the auditor has obtained sufficient appropriate evidence to support his or her opinions on the financial statements and on compliance.]
- c. The date of the final assembly of the audit file. [This answer is incorrect. AS No. 103 indicates that the final assembly and completion of the audit file should occur within 60 days of the report release date. SAS No. 103 refers to this date as the documentation completion date.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (GSATG093)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Who is responsible for preparing a management representation letter?
 - a. Client.
 - b. Client management.
 - c. Auditor.
 - d. Do not select this answer choice.
2. AICPA Audit Guide GAS/A-133, paragraph 8.70 indicates that with respect to compliance requirements affecting federal awards, auditors should consider specific representations. Which of the following is **not** considered one of the representations?
 - a. Management is responsible for establishing and maintaining effective internal control over financial reporting.
 - b. 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 have complied, in all material respects, with those requirements.
 - c. Management is responsible for and has accurately prepared the summary schedule of prior audit findings to include all findings required to be included by OMB Circular A-133.
 - d. Management has provided to the auditor its interpretations of any compliance requirements that have varying interpretations.
3. SAS No. 99 provides guidance in which of the following aspects of audit planning?
 - a. Compliance auditing in accordance with the Yellow Book and the Single Audit Act Amendments.
 - b. Analytical procedures the auditor is required to apply during the planning stage of the audit.
 - c. Consideration of fraud in the financial statements audit.
 - d. Detection of illegal acts by the client.
4. When is an auditor attempting to obtain a representation letter, which of the following statements is incorrect if the responsible administrative official refuses to sign the representation letter because the representations relating to the period occurred prior to the beginning of his or her term in office?
 - a. An auditor may obtain a separate letter regarding the completeness of the minutes from the clerk responsible for keeping the minutes for the legislative body or governing board.
 - b. An auditor may obtain certain representations from officials other than those signing the standard letter.
 - c. An auditor may proceed with the audit without obtaining any additional representation.
 - d. An auditor may consider obtaining representations from management of primary governments concerning matters that may affect the unit they are auditing.

5. According to the *Government Auditing Standards*, which of the following is an additional requirement for a supervisory review?
- a. Supervisory review evidence should be documented before the audit report is issued.
 - b. Review notes should be cleared before the documentation completion date.
 - c. Indication of the auditor's review on each specific workpaper.
 - d. Do not select this answer choice.
6. Which of the following statements regarding drafting financial statements is most accurate?
- a. According to the Yellow Book, an auditor's involvement in drafting financial statements will impair the auditor's independence.
 - b. An auditor must consider SAS No. 103, *Audit Documentation* requirements when determining their involvement in drafting the financial statements.
 - c. An auditor's involvement in financial statement preparation may indicate a control deficiency.
 - d. The auditor's role and responsibility for the financial statements should be documented in the financial statement notes.
7. How should the data collection form be signed?
- a. In the audit firm's name.
 - b. In the engagement partner's name.
 - c. In the reviewing attorney's name.
 - d. By the chief executive officer.
8. Which of the following would cause the filing of 2004 Data Collection Form to be rejected?
- a. Using less than one line per federal program.
 - b. Not binding the data collection form into the reporting package.
 - c. Submitting a complete reporting package.
 - d. The direct award box is left blank.
9. An audit performed in accordance with the *Government Auditing Standards* requires a report based on each of the following elements **except**:
- a. All material weaknesses in internal controls over financial reporting.
 - b. All significant deficiencies in internal controls over financial reporting.
 - c. All internal control deficiencies.
 - d. Do not select this answer choice.

10. The significance of a control deficiency in a single audit depends on which of the following?
- a. Complexity of the subject matter.
 - b. Potential for noncompliance.
 - c. Qualifications of persons performing the work.
 - d. Do not select this answer choice.
11. All of the following are considered primary purposes of an auditor's communication with those charged with governance **except**:
- a. Clearly communicate an overview of the audit scope, the auditor's responsibilities, and the timing of the audit.
 - b. Provide timely observations arising from the audit that are relevant to oversight of the financial reporting process.
 - c. Obtain relevant audit-related information from those charged with governance.
 - d. Provide a list of specific representations that should be obtained.
12. Auditors may adopt documentation completion periods that are shorter than the _____ days, as required by SAS No. 103.
- a. 30.
 - b. 45.
 - c. 50.
 - d. 60.
13. Which of the following statements is most accurate regarding workpaper retention?
- a. Auditors retain all workpapers for a period no shorter than ten years from the report release date.
 - b. Auditors may, but are not required to allow the oversight agency full and timely access to the workpapers.
 - c. Auditors must extend the workpaper retention period if notified in writing by the oversight agency.
 - d. Auditors must retain all single audit workpapers for at least three years after the date of issuance of the auditor's report(s) to the auditee.

Lesson 2: Reporting under the Single Audit

INTRODUCTION

Single Audit Reports

This lesson discusses the various auditor reports that are unique to single audits. Separate guides entitled *PPC's Guide to Audits of Local Governments*, *PPC's Guide to Audits of Nonprofit Organizations*, and *PPC's Guide to Auditor's Reports* give general guidance on audit reports on financial statements. This lesson concentrates on the reports that are unique to single audits.

The auditor is provided with an understanding of the basic elements and the intended purpose of the various single audit auditor's reports in this lesson. This understanding is necessary to enable the auditor to tailor the reports to various specific situations. It is not possible to illustrate or to even anticipate all of the many situations that may be encountered by the auditor.

Also discussed in this lesson is the dating of auditor's reports, report due dates, report distribution, combined reports, Yellow Book reports, OMB Circular A-133 reports, summary schedule of prior audit findings, schedules of findings and questioned costs, and other related reporting matters.

Learning Objectives:

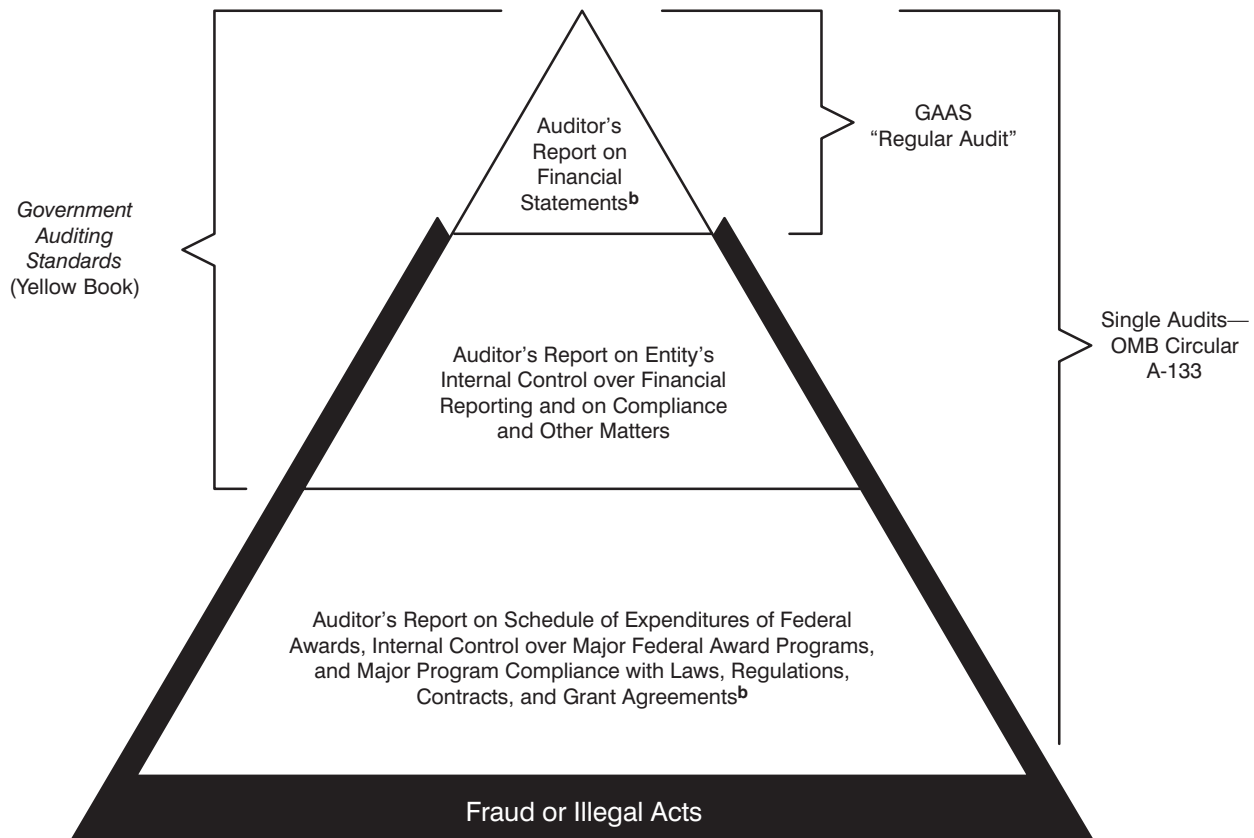
Completion of this lesson will enable you to:

- Explain how to date an auditor's report and determine when audit reports are due, who is responsible for submitting the reports, to whom and where the reports should be submitted, and what reports should be submitted.
- Compose a report on internal control over financial reporting and on compliance and other matters required by *Government Auditing Standards*.
- Prepare and report on the schedule of expenditures of federal awards.
- Compose a report on compliance with requirements applicable to each major program and on internal control over compliance required by OMB Circular A-133.
- Describe the procedures an auditee uses to prepare a summary schedule of prior audit findings and distinguish between fraud or illegal acts, violations of provisions of contracts or grant agreements, and abuse; and communicate control deficiencies and other comments.
- Prepare a report of all findings meeting specified criteria in a schedule of findings and questioned costs.

Auditor's Reports

Addressing the Report. The reports should be addressed to the individual or group who retained the auditor, usually the legislative authority of the governmental unit; e.g., the city council, school board, county commission or the board of directors of a nonprofit organization. Some auditors do this referring to *members* of the governing body (e.g., "The Honorable Members of the City Council" or "The Board of Trustees of the [Name of Organization]"), and they may also include the chief legislative or administrative officer in the address (e.g., "Honorable Mayor and Members of the City Council" or "The President and Members of the Board of Directors of [Name of Organization]").

Exhibit 1-1 presents a graphic illustration of the reports that should or may be issued at the conclusion of a regular GAAS audit versus those of a Yellow Book audit and a single audit. Exhibit 1-2 presents the same information in a matrix format.

Exhibit 1-1**Reports Required by GAAS, Government Auditing Standards, and Single Audit^a****Notes:**

- ^a The AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide), includes illustrated auditor's reports that comply with single audit guidance.
- ^b The illustrative auditor's reports in the GAS/A-133 AICPA Audit Guide combine the report on the schedule of expenditures of federal awards with the report on the financial statements. If the schedule is not presented with the financial statements, the illustrative reports combine the report on the schedule with the report on compliance and on internal control required by OMB Circular A-133.

* * *

Exhibit 1-2**Required Auditor's Reports^a**

	GAAS FINANCIAL AUDIT	GOVERNMENT AUDITING STANDARDS^b	SINGLE AUDIT^b
FINANCIAL STATEMENTS	Standard report on financial statements	SAME	SAME
INTERNAL CONTROLS	Written communication of significant deficiencies and material weaknesses	Report on internal control over financial reporting	SAME
	N/A	N/A	Report on internal control over major program compliance with laws, regulations, contracts, and grant agreements
COMPLIANCE AND OTHER MATTERS	N/A	Report on compliance with laws, regulations, contracts, and grant agreements, and other matters—Financial statement level	SAME
	N/A	N/A	Report on compliance with laws, regulations, contracts, and grant agreements—Major program level
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS	N/A	N/A	Report on schedule of expenditures of federal awards

Notes:

- ^a The *AICPA Audit Guide, Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide), includes illustrated auditor's reports that comply with single audit guidance.
- ^b The illustrative reports in the GAS/A-133 AICPA Audit Guide combine (a) the reporting on internal control over financial reporting and on compliance and other matters required by *Government Auditing Standards* into a single report, (b) the reporting on internal control over major programs and major program compliance into a single report, and (c) the reporting on the schedule of expenditures of federal awards with the report on the financial statements. If the schedule is not presented with the financial statements, the illustrative reports combine the report on the schedule with the report on compliance and on internal control required by OMB Circular A-133. *Government Auditing Standards* and OMB Circular A-133 allow auditor's reports to be combined or separated. However, auditors should use caution when deviating from the illustrative reports.

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This lesson covers the following types of reporting:

- Reporting on financial statements in a single audit.
- Reporting 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*; i.e., the Yellow Book.

- Reporting on the schedule of expenditures of federal awards.
- Reporting on compliance with requirements applicable to each major program and on internal control over compliance in accordance with OMB Circular A-133.

Authoritative Literature

The authoritative pronouncements that establish requirements or provide guidance that most directly affect the auditor's reporting and communication requirements are as follows:

- SAS No. 8 (AU 550), *Other Information in Documents Containing Audited Financial Statements*.
- SAS No. 29 (AU 551), *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as amended.
- SAS No. 58 (AU 508), *Reports on Audited Financial Statements*, as amended.
- SAS No. 59 (AU 341), *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, as amended by SAS No. 114, *The Auditor's Communication With Those Charged With Governance*.
- SAS No. 62, as amended by SAS No. 77 (AU 623), *Special Reports*.
- SAS No. 74 (AU 801), *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*. (SAS No. 74 has not been amended to reflect the requirements of the Single Audit Act Amendments or the 1997 OMB Circular A-133.)
- SAS No. 87 (AU 532), *Restricting the Use of an Auditor's Report*.
- SAS No. 93, *Omnibus Statement on Auditing Standards—2000*.
- SAS No. 98, *Omnibus Statement on Auditing Standards—2002*.
- SAS No. 103 (AU 339), *Audit Documentation*.
- SAS No. 112 (AU 325A), *Communicating Internal Control Related Matters Identified in an Audit*.
- SAS No. 113, *Omnibus Statement on Auditing Standards—2006*.
- SAS No. 114 (AU 380), *The Auditor's Communication with Those Charged with Governance*.
- SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*.
- United States Government Accountability Office (GAO), *Government Auditing Standards, July 2007 Revision* (Yellow Book). (A link to the Yellow Book is included in PPC's *Government Documents Library* at Gov. Doc. No. 2.)
- OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (a link to Circular A-133 is included in PPC's *Government Documents Library* at Gov. Doc. No. 8).
- AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (with conforming changes as of August 1, 2008) (GAS/A-133 AICPA Audit Guide).

GAS/A-133 AICPA Audit Guide. The GAS/A-133 AICPA Audit Guide provides reporting guidance and illustrative examples of auditor's reports issued in accordance with *Government Auditing Standards* (the Yellow Book) and OMB Circular A-133. Conforming changes made in the GAS/A-133 AICPA Audit Guide are effective for audits of financial statements for which fieldwork is completed after the guide is issued, subject to the effective date of underlying pronouncements.

Single Audit Report Examples

The single audit report illustrations in this lesson are based on the GAS/A-133 AICPA Audit Guide. The GAS/A-133 AICPA Audit Guide recommends issuing the following three reports:

- An opinion on the financial statements, including a SAS No. 29 opinion on the schedule of expenditures of federal awards. (If the schedule is not presented with the financial statements, the report on the schedule is combined with the report on compliance and on internal control required by OMB Circular A-133.)
- One Yellow Book report addressing internal control over financial reporting and compliance and other matters.
- One Single Audit report including a report on internal control and an opinion on compliance.

In addition, auditors are required to prepare a schedule of findings and questioned costs.

Recent Developments in Reporting Guidance

When necessary, the AICPA makes conforming changes to other SASs, SOPs, and accounting and auditing guides (such as the GAS/A-133 AICPA Audit Guide) when new pronouncements are issued. Those conforming changes are reflected in the reporting guidance in this lesson.

Current AICPA and GAO Developments. In October 2008, the AICPA issued SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*, which supersedes SAS No. 112 (AU 325A) effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation of SAS No. 115 is permitted. SAS No. 115 revises the definitions of the terms *material weakness* and *significant deficiency* that had been established in SAS No. 112 and are included in the Yellow Book.

In November 2008, the GAO released interim guidance that enables auditors to early implement SAS No. 115 (AU 325) on Yellow Book audits. However, although the GAO has released interim guidance on applying SAS No. 115 on Yellow Book audits, OMB Circular A-133 and other similar federal regulations or audit guides have not been updated to reflect new internal control definitions for reporting on internal control over compliance. The AICPA Audit Risk Alert, *Government Auditing Standards and Circular A-133 Developments—2008*, states that it would not be appropriate to use SAS No. 115 definitions for reporting on internal control over compliance until OMB Circular A-133 or other regulations or guides are amended to allow usage of new updated definitions. When this *Guide* went to press, such amendments had not yet been made and the AICPA had not yet developed illustrative reports that reflect SAS No. 115. Auditors should monitor the AICPA's Governmental Audit Quality Control website at <http://gaqc.aicpa.org/> for release of such reports.

DATING OF AUDITOR'S REPORTS

Auditor's Report on Financial Statements

SAS No. 103, *Audit Documentation*, states that the date of the auditor's report on the financial statements should be no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the opinion. This will usually be a date later than the completion of fieldwork because it encompasses review of the audit work; preparation of financial statements and disclosures, and single audit reports; obtaining a management representation letter, the attorneys' letter; and subsequent events review. In many instances, the auditor will need to have their clients review and approve the completed financial statements before they would have obtained sufficient audit evidence to support the opinion. Accordingly, the subsequent event period would be expanded to the date that sufficient audit evidence is obtained. Management's representation letter should be dated as of the date of the auditor's report on the financial statements. Although this requirement does not mean that the auditor needs to physically have management's representation letter on the date of the auditor's report, on or before the date of the auditor's report, management will need to have reviewed the final representation letter and confirmed to the auditor that they will sign the letter. The auditor will need to have the signed management representation letter prior to releasing the auditor's report since management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

Dual Dating of Auditor's Report. SAS No. 1 (AU 530.05) is the authoritative literature that discusses the effect of subsequent events on the auditor's report date. If a subsequent event that is disclosed in the financial statements occurs after the original date of the auditor's report but before the statements are issued, auditors can choose between two methods for dating their report. The report may be dated as of the later date or may be dual dated. If the report is dated as of the later date, the auditor's responsibility for subsequent events is extended to the date of the report. In this situation, audit procedures directed toward determining subsequent events should be extended to the date of the report. If the report is dual-dated, the auditor's responsibility is limited to the specific event. If the auditor's report is dual dated due to the disclosure of a subsequent event, the auditor should consider obtaining additional representations relating to the subsequent event.

Auditor's Report on Schedule of Expenditures of Federal Awards

As discussed in Paragraph 12.26 of the GAS/A-133 AICPA Audit Guide, since the auditor's report on the schedule of expenditures of federal awards is an opinion that the schedule is fairly stated in all material respects *in relation to the basic financial statements taken as a whole* rather than an opinion on the schedule as a stand-alone document, the date of the report should always be the same as the date of the auditor's report on the basic financial statements. The GAS/A-133 AICPA Audit Guide recommends combining the reporting on the schedule with the report on the financial statements.

As discussed in note b to Exhibit 1-2, the auditor's report on the schedule may in some instances be included with the auditor's report on compliance and on internal control over compliance issued in accordance with OMB Circular A-133. In those instances, Paragraph 12.28 of the GAS/A-133 AICPA Audit Guide indicates that the date of the report issued in accordance with OMB Circular A-133 should, if possible, be the same as the date of the report on the basic financial statements. If using the same date is not possible because the audit procedures satisfying OMB Circular A-133 requirements are not complete as of the date of the financial statement report, the auditor has two alternatives:

- Issue a separate report on the schedule the following and use the same date as that used for the report on the basic financial statements.
- Dual date the report. (The date relating to the schedule should be the same as that used on the report on the basic financial statements.)

If an auditee is required to have a single audit but the auditor is engaged to audit only the financial statements (and not the federal awards), the audit of the financial statements must be performed in accordance with *Government Auditing Standards*. This is the case even if the auditee would not be subject to a Yellow Book audit except for the requirement to have a single audit. If the auditor is engaged to audit only the federal programs in accordance with OMB Circular A-133 (and not the basic financial statements), the auditor should report on the schedule in accordance with SAS No. 58; *Reports on Audited Financial Statements* (AU 508). It is believed that when the audit of the financial statements and the single audit are conducted by different audit firms, the report on the schedule of expenditures of federal awards still should be in relation to the basic financial statements taken as a whole.

Yellow Book Report

The *Government Auditing Standards* (Yellow Book) report on internal control is based on the review of internal control in accordance with generally accepted auditing standards. No procedures are required beyond those required as part of the regular audit procedures. For this reason, the date of the report on internal control over financial reporting should always be the same as the date of the auditor's report on the basic financial statements.

The Yellow Book report on compliance with applicable laws and regulations is not designed to provide an opinion or other assurance on overall compliance with laws and regulations, and no tests are required beyond those required as part of the regular audit procedures. For this reason, the date of the compliance report should always be the same as the date of the auditor's report on the basic financial statements.

Report on Federal Programs

As discussed in Paragraph 12.27 of the GAS/A-133 AICPA Audit Guide, generally the report on compliance and internal control over compliance related to major federal programs required by OMB Circular A-133 should be

dated the same as the report on the financial statements. However, when audit procedures satisfying the requirements of OMB Circular A-133 (additional single audit procedures) are completed after that date, the report should be dated no earlier than the date that the auditor has obtained sufficient appropriate audit evidence to support the report. 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 audit of compliance.

If the report on the financial statements is issued prior to performing the additional single audit procedures, the auditor should carefully consider the effect on the financial statements of possible findings that may result from the single audit procedures. In some instances, it may be clear that the effect of any findings will not have a material effect on the financial statements (for example, when the entire amount of the financial awards is immaterial to the financial statements). In other instances, findings could have a material effect on the financial statements. If this is the case, the report on the financial statements should not be issued and should be dated no earlier than the date the auditor has obtained sufficient appropriate evidence to satisfy the reporting requirements of OMB Circular A-133.

Other Auditors

It is not unusual in governmental auditing for certain component units, funds, or groups of funds to be audited by other auditors. While rare, a similar situation may also occur in audits of nonprofit organizations. In those situations, it is desirable, but almost impossible, to arrange for the completion of the fieldwork for each constituent entity on the same date. Accordingly, if the completion of fieldwork for any major constituent entity is considerably earlier than that of the primary entity, subsequent event procedures should be applied to the constituent entity's activities from the completion of its fieldwork to the primary entity's report date. The date of the report on the financial statements of the primary reporting entity should not be earlier than the date auditors have obtained sufficient appropriate evidence to support the opinion for any of the major constituent entities.

SUBMISSION OF AUDIT REPORTS

This section discusses when audit reports are due, who is responsible for submitting the reports, to whom and where the reports should be submitted, what reports must be submitted, reporting packages, and how to bind the reports. Submission of audit reports is discussed in the GAS/A-133 AICPA Audit Guide beginning at Paragraph 12.47.

Audit Report Due Dates

Single Audits. OMB Circular A-133 at Section 320(a) states that the reporting package (which includes the audit reports) must be submitted no later than 30 days after the reports are received from the auditors but no later than nine months after the end of the audit period. The Federal Audit Clearinghouse considers the submission requirement complete when it has received the electronic submission of both the data collection form and the reporting package. Section 300(e) of OMB Circular A-133 further indicates that when extensions to the report submission due date are granted by the cognizant or oversight agency for audit, the *auditee* should notify the federal clearinghouse designated by OMB and each pass-through entity providing federal awards of the extension.

OMB Circular A-133 indicates that cognizant and oversight agencies for audit can extend due dates. Generally, all that is required to obtain an extension is a telephone call or letter to the agency indicating the additional time requested and stating the reason for the delay in completing the audit. However, it is recommended that the request be made in writing. The Circular at Section 300(e) further indicates that when extensions to the report submission due date are granted by the cognizant or oversight agency for audit, the *auditee* should notify the federal clearinghouse designated by OMB and each pass-through entity providing federal awards of the extension.

Receiving a due date extension should not be considered automatic. The writers of this course have been told that cognizant agencies have been looking at the reason for which an extension is requested. Many cognizant agencies will not grant an extension if there is not a good reason for the reporting package to be late. In addition, OMB staff have informed the authors that the OMB plans to propose revisions to OMB Circular A-133 in July 2009. The OMB is expected to propose changes in several areas, including eliminating the ability of federal agencies to grant waivers for late filing except in cases of extreme emergency. Auditors should be alert for this and other changes to OMB requirements.

Loss of Low-risk Auditee Status. If the reporting package is late and an extension was not granted, a recipient may be disqualified from being a low-risk auditee the next year. Auditors may want to contact the relevant cognizant or oversight agency with questions in this area including the date of prior-year submissions. The Federal Audit Clearinghouse's searchable database can also be used to look up the date of prior year submissions. It can be accessed at <http://harvester.census.gov/fac>.

Yellow Book Audits. In many instances, audits that are not single audits may be required by law, regulation, agreement, contract, or policy to be performed in accordance with the Yellow Book. For those audits, the Yellow Book does not specify a due date. The auditor should, however, be aware that the law, regulation, agreement, contract, or policy requiring the audit may specify a reporting due date.

Responsibility for Submitting Reports

The Yellow Book and OMB Circular A-133 at Section 300(e) indicate that the auditee (recipient or subrecipient) is responsible for ensuring appropriate submission of the audit reports to appropriate government officials or organizations. The Yellow Book, at Paragraph 5.44(c), states the auditor should clarify report distribution responsibilities with the auditee. Further, if the audit firm is responsible for report distribution, it should reach agreement about which officials or organizations should receive the report and how it will be made available to the public. Auditors should document any limits on report distribution, such as for security purposes. It is recommended that report distribution responsibilities be included in the engagement letter.

This course suggests that independent auditors submit the single audit reports only to the engaging entity (client). In September 2008, the OMB released a new version of the data collection form and the Federal Audit Clearinghouse revised the submission processes for the data collection form and the single audit reporting package. Beginning with audits of fiscal periods ending in 2008, the collection form and the reporting package must be submitted electronically to the Federal Audit Clearinghouse using the Internet Data Entry System (IDES). Part of the electronic submission process requires the single audit reporting package to be contained in a single unsecured PDF file that is uploaded to the IDES. Both the auditor and the auditee have responsibilities in the submission and certification process through IDES. This will require additional coordination between the auditor and client personnel, and may require the auditor to deliver the single audit reporting package in an electronic format. Many auditors submit the reports along with a transmittal letter that describes this process and includes instructions as to distribution of the reports by the client.

In instances when it is not possible or practical for the auditor to avoid submitting the reports, this course recommends obtaining permission, preferably in writing, from the client and a list of individuals or organizations who are to receive copies. Such a policy is consistent with Rule 301 of the AICPA's *Code of Professional Conduct*, which prohibits a member from disclosing confidential client information without the specific consent of the client.

Report distribution requirements are met whether the reports are submitted by the audited entity or the auditor. In those situations where the auditor is engaged by a governmental department or agency to audit a subrecipient, the auditor should distribute the reports to the engaging governmental department or agency.

Additional Electronic Submission Requirements of Certain Federal Agencies. In addition to the reporting requirements under OMB Circular A-133, several federal agencies have issued regulations requiring that certain financial and compliance information be submitted electronically (e.g., the financial and reporting compliance requirements of the Department of Housing and Urban Development through HUD REAC). Reporting under those regulations does not replace the normal submission requirements to the Federal Audit Clearinghouse.

Additional Submission by Subrecipients. Section 320(e) of the Circular provides additional instructions when the auditee is a subrecipient. Subrecipients should also submit one copy of the reporting package to the pass-through entity when (a) an audit finding included in the schedule of findings and questioned costs relates to awards funded through the pass-through entity or (b) the current status of a prior audit finding is reported in the summary schedule of prior audit findings. When neither of these conditions exists, the subrecipient should submit either of the following to the pass-through entity:

- a. A copy of the reporting package.

b. Written notification that:

- (1) An audit of the program(s) funded through the entity [include the name(s), amount(s), and CFDA number(s)] was completed in accordance with OMB Circular A-133 and the audit period.
- (2) The schedule of findings and questioned costs disclosed no findings relating to awards funded through the entity.
- (3) The summary schedule of prior audit findings did not report the status of any audit finding relating to programs previously funded through the entity.

Clearinghouse Responsibilities. The Federal Audit Clearinghouse has the responsibility to distribute the reporting packages received to applicable federal awarding agencies, maintain a database of completed audits, provide appropriate information to federal agencies, and follow up with known auditees that have not submitted the required data collection forms and reporting packages. The database of single audit data is available online at the Federal Audit Clearinghouse website at <http://harvester.census.gov/sac>.

American Recovery and Reinvestment Act of 2009 Considerations. Under the American Recovery and Reinvestment Act of 2009 (Recovery Act), the Federal Audit Clearinghouse (FAC) is required to make publicly available on the internet all single audit reports filed with the FAC for fiscal years ending September 30, 2009, and later. There will be a link from www.recovery.gov to the single audit reports. As this course went to press, it was unclear whether this new requirement applies to all single audit reports, or just those for entities that expend Recovery Act funds. Auditors should be aware that the entire reporting package may be publicly available due to this new Recovery Act requirement.

Reporting Package

The reporting package referred to in previous paragraphs, as described at Section 320(c) of OMB Circular A-133, includes the following:

- Financial statements.
- Schedule of expenditures of federal awards.
- Summary schedule of prior audit findings.
- Auditor's report(s), including the schedule of findings and questioned costs.
- Corrective action plan.

Should Reports Be Bound?

Beginning with single audits of fiscal periods ending in 2008, the single audit reporting package must be submitted electronically to the Federal Audit Clearinghouse using the Clearinghouse's IDES. The single audit reporting package is required to be contained in a single unsecured PDF file that is uploaded to the IDES; paper copies will not be accepted. This may require the auditor to deliver the single audit reporting package in an electronic format as well as in bound reports. The data collection form is also required to be completed and submitted using the IDES. The data collection form is not part of the auditor's single audit reporting package and should not be bound with the reporting package. The 1988 Yellow Book stated that the auditor's reports on internal control, compliance, and the report on the financial statements should ". . . normally be bound together . . ." This comment was not included in subsequent editions of the Yellow Book. OMB Circular A-133 does not comment on whether the reports should be bound together.

There are several ways that auditors and auditees can approach binding reports that are part of the reporting package, including the following:

- a. One package that includes the financial statements and auditor's report, the Yellow Book reports, and the single audit reports, with all the reports bound together.

b. One package that includes two parts (each bound together):

- The financial statements and auditor's report and the Yellow Book reports.
- The single audit reports.

Note: The Yellow Book reports may be bound with either of these parts. One factor that may affect the decision on where to place the Yellow Book reports is the reporting requirements that the auditee must comply with. For example, if a state agency requires the auditee to submit the financial statements and Yellow Book reports, the auditee may choose to bind the Yellow Book reports with the financial statements and auditor's report.

c. One package that includes three parts (each bound together):

- The financial statements and auditor's report.
- The Yellow Book reports.
- The single audit reports.

The first option is the simplest if all of the reports will be (or must be) distributed each time the auditee sends a reporting package to applicable parties (e.g., pass-through entities, citizens, etc.) Also, in this option the bound reporting package would correspond to the same reporting package delivered in the electronic format to be used for filing with the Federal Audit Clearinghouse using the IDES. If an entity chooses option a, they may still elect to separately issue the financial statements and auditor's report thereon.

Options b and c provide advantages in terms of flexibility of grouping different reports for various parties and purposes. Auditors should be aware that selection of option b or c may affect the SAS No. 29 (AU 551) reporting on the schedule of expenditures of federal awards. If the schedule is not presented with the financial statements (for example, a separate single audit package is issued), the required SAS No. 29 reporting on the schedule may be combined with the report on compliance and on internal control required by OMB Circular A-133.

When practical, it is recommended that all auditor reports, financial statements, and schedule of expenditures of federal awards be bound together for submission. (The data collection form should not be bound with the reporting package.) Some firms also include the corrective action plan if it is available. Experience has shown that the greater the number of documents, the more likely that one or more will, for one reason or another, not be submitted or, if they are submitted, may be separated or lost by the departments or agencies receiving the reports. However, there are a number of options for binding the reports as well as sound reasons for choosing one option over another.

Binding—Auditor-submitted versus Client-submitted Package. Regardless of the binding option selected, auditees should consider binding the reports under a plain cover (versus the audit firm's report cover). The auditor's responsibility for the information that accompanies the financial statements depends on whether the information is in a client-prepared or auditor-submitted document (package) and on the terms of the engagement. Auditors have a responsibility to report on all the information in documents containing audited financial statements that they submit to clients or others. As a result, if the reporting package is considered auditor-submitted, the auditor should clearly indicate the schedules that are unaudited (i.e., the summary schedule of prior audit findings and the corrective action plan). If the reporting package is client-submitted, the auditor has no additional reporting responsibility for the information that accompanies the financial statements.

Order of the Bound Documents

There are no standards covering in what order the documents should be bound. It is believed the following is a logical sequence to bind the reports and financial statements.

- a. Auditor's report on the financial statements and schedule of expenditures of federal awards.
- b. Financial statements, including notes to financial statements and required supplementary information.

- c. Schedule of expenditures of federal awards.
- d. Summary schedule of prior audit findings.
- e. Auditor's report on compliance and on internal control over financial reporting (Yellow Book report).
- f. Auditor's report on compliance with requirements applicable to each major program and on internal control over compliance (OMB Circular A-133 major program compliance report).
- g. Schedule of findings and questioned costs.

Other sequences that take into account the binding option selected may also be acceptable.

Table of Contents

This course suggests a table of contents be included in the front of the bound document including all of the single audit reports. The table of contents should be similar to the list in the paragraph above, but it should include the exact title of each report.

Submission of Amended Reporting Packages

The procedures for resubmitting a single audit reporting package and/or a revised data collection form will depend on the method that was used to make the original submission to the Federal Audit Clearinghouse. Various submission methods (i.e., on-line filing through the Internet, on CD-ROM, or paper) have been available (or required) for different reporting years. Auditors or Auditees may also contact the Federal Audit Clearinghouse at (888) 222-9907 to discuss submitting amended reporting packages.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. According to SAS No. 103, what date should the auditor's report reflect?
 - a. Date the fieldwork is completed.
 - b. Date of a subsequent event after the date the financial statements are issued.
 - c. When the auditor has obtained sufficient appropriate evidence.
15. Which of the following statements regarding audit report due dates is most accurate?
 - a. An auditor can extend a reporting package due date with a simple call to the oversight agency.
 - b. The reporting package must be submitted no later than 60 days after the reports are received from the auditors.
 - c. Most oversight agencies will grant a due date extension, regardless of the reason.
16. What is one thing an auditor/auditee should not do when binding a reporting package?
 - a. Include the data collection form.
 - b. Include the corrective action plan.
 - c. Bind the reports under the audit firm's report cover.
 - d. Include a table of contents.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. According to SAS No. 103, what date should the auditor's report reflect? **(Page 313)**

- a. Date the fieldwork is completed. [This answer is incorrect. Before SAS No. 103, the completion of fieldwork was typically used as the report date.]
- b. Date of a subsequent event after the date the financial statements are issued. [This answer is incorrect. If a subsequent event that is disclosed in the financial statements occurs after the original date of the auditor's report but before the statements are issued, the report may be dated as of the later date or dual-dated.]
- c. **When the auditor has obtained sufficient appropriate evidence. [This answer is correct. SAS No. 103 states that the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the opinion.]**

15. Which of the following statements regarding audit report due dates is most accurate? **(Page 315)**

- a. **An auditor can extend a reporting package due date with a simple call to the oversight agency. [This answer is correct. OMB Circular A-133 indicates that cognizant and oversight agencies for audit can extend due dates. Generally, all that is required to obtain an extension is a telephone call or letter to the agency indicating the additional time requested and stating the reason for the delay in completing the audit. However, it is recommended that the request be made in writing.]**
- b. The reporting package must be submitted no later than 60 days after the reports are received from the auditors. [This answer is incorrect. OMB Circular A-133 at Section 320(a) states that the reporting package (which includes the audit reports) must be submitted no later than 30 days after the reports are received from the auditors but no later than nine months after the end of the audit period.]
- c. Most oversight agencies will grant a due date extension, regardless of the reason. [This answer is incorrect. Receiving a due date extension should not be considered automatic. The writers of this course have been informed that cognizant agencies have been looking at the reason for which an extension is requested. Many agencies will not grant an extension if there is not a good reason for the reporting package to be late.]

16. What is one thing an auditor/auditee should **not** do when binding a reporting package? **(Page 318)**

- a. **Include the data collection form. [This answer is correct. The data collection form should *not* be bound with the reporting package.]**
- b. Include the corrective action plan. [This answer is incorrect. Firms can include the corrective action plan if it is available. However, experience has shown that the greater the number of documents, the more likely that one or more will, for one reason or another, not be submitted or, if they are submitted, may be separated or lost by the departments or agencies receiving the reports.]
- c. Bind the reports under the audit firm's report cover. [This answer is incorrect. Regardless of the binding option selected, reports can be bound under the audit firm's report cover. However, auditees should consider binding the reports under a plain cover (versus the audit firm's report cover).]
- d. Include a table of contents. [This answer is incorrect. This course suggests that a table of contents be included in the front of the bound document including all of the single audit reports; including the exact title of each report.]

REPORT ON THE BASIC FINANCIAL STATEMENTS

As indicated in Exhibit 1-1 and Exhibit 1-2, financial reporting under the Yellow Book and OMB Circular A-133 includes reporting on the basic financial statements in accordance with generally accepted auditing standards, in addition to reporting in accordance with *Government Auditing Standards*. The purpose of this course is to discuss the various audit reports that are unique to single audits. This section will, therefore, discuss only selected items (those unique to the single audit process) relative to the auditor's report on the basic financial statements. *PPC's Guide to Audits of Local Governments*, *PPC's Guide to Audits of Nonprofit Organizations*, and *PPC's Guide to Auditor's Reports* give general guidance for audit reports on basic financial statements.

References to *Government Auditing Standards*

The Yellow Book at Paragraph 5.05 states "When auditors comply with all applicable GAGAS requirements, they should include a statement in the auditors' report that they performed the audit in accordance with GAGAS." (GAGAS refers to generally accepted government auditing standards, also referred to as *Government Auditing Standards* or the Yellow Book.) Therefore, the Yellow Book audit report(s) on internal control over financial reporting and on compliance and other matters, as well as the other audit reports issued in a single audit, should refer to *Government Auditing Standards*.

The 2007 Yellow Book, beginning at Paragraph 1.12, provides guidance for referring to GAGAS requirements when the auditor is required to or voluntarily follows *Government Auditing Standards*. Two types of "compliance statements" about adherence to these standards in reports issued in single audit engagements are described as follows:

- a. An *unmodified GAGAS compliance statement* states the audit was performed in accordance with *Government Auditing Standards*. This type of statement should be used in the audit report when: (1) all applicable unconditional and presumptively mandatory Yellow Book requirements have been followed, or (2) all unconditional requirements have been followed, and the justification for any departures from applicable presumptively mandatory requirements has been documented and the objectives of those requirements have been achieved through other means.
- b. A *modified GAGAS compliance statement* states either (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*.

If a Yellow Book requirement is not followed, the auditor should document the reason, and the significance to the audit objectives should also be assessed and documented. The auditor should then make a determination about how to refer to *Government Auditing Standards* in the reports issued in the single audit engagement. If the auditor's statement about compliance with *Government Auditing Standards* is modified as described in item b. of the paragraph above, the auditor's report should disclose the applicable requirements that were not followed, the reasons for not following the requirements, and how not following the requirements affected, or could have affected, the audit and the assurance provided. The impact of the noncompliance with Yellow Book requirements in relation to generally accepted auditing standards should also be considered. For example, a scope limitation would require an auditor to consider both the AICPA reporting standards and the Yellow Book reporting requirements.

The reports should also cite the AICPA standards as required by SAS No. 58 (AU 508), *Reports on Audited Financial Statements*. The illustrative reports in Chapter 4, Appendix A, Examples 4-1 and 4-2 of the GAS/A-133 AICPA Audit Guide suggest that the references be as 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.

The Yellow Book does not prohibit an entity from issuing separate financial statements for purposes other than complying with *Government Auditing Standards*, such as for the purpose of issuing bonds. In such cases, Para-

graph 5.06 of the Yellow Book and Paragraph 4.26 of the GAS/A-133 AICPA Audit Guide do not require the auditor's report to specifically cite *Government Auditing Standards*. The separate report on the financial statements would only need to conform to the requirements of generally accepted auditing standards.

References to Separately Issued Internal Control and Compliance Report

When providing an opinion or a disclaimer on financial statements, the Yellow Book states that the auditor must also report on internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements. The Yellow Book provides two options. The auditor's report on the financial statements should either—

- Disclose the scope and the results of testing internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements, or
- Include a statement that refers to separate reports on internal control and compliance. The scope and the results of testing internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements should be described in the separate report.

The AICPA has not issued report examples combining the report on the financial statements with the report on internal control over financial reporting and compliance. Also, because Paragraph 4.05b of the GAS/A-133 AICPA Audit Guide recommends issuing separate reports this course suggests issuing separate reports. When separate reports are issued, as recommended by Paragraph 4.05b of the GAS/A-133 AICPA Audit Guide, the following paragraph is added after the opinion paragraph of the report of the financial statements, referring the reader to the report on internal control and compliance:

In accordance with *Government Auditing Standards*, we have also issued our report dated [Date] on our consideration of [Name of Governmental Entity or Nonprofit Organization]'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 an opinion 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 last sentence of the report paragraph illustrated in the preceding paragraph is required by the Yellow Book. If separate reports are issued, in addition to referring to the separate reports, Paragraph 5.09 of the Yellow Book states that the report on the financial statements should state that the reports on internal control over financial reporting and compliance with laws and regulations and provisions of contracts or grant agreements are an integral part of an audit conducted under *Government Auditing Standards* and important for assessing the results of the audit.

Government Auditing Standards also require that the auditor state whether the tests performed provide sufficient, appropriate evidence to support an opinion on the *effectiveness* of internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts and grant agreements. Since neither the AICPA nor GAO has issued standards for issuing an opinion on internal control in a financial audit, the report on internal control over financial reporting and compliance usually includes a statement to the effect that providing such assurance was not an objective of the audit.

The question has arisen as to whether the paragraph illustrated above should also refer to the additional report on compliance and on internal control over compliance required by OMB Circular A-133. While the Circular and the GAS/A-133 AICPA Audit Guide include no similar requirement, it is believed a practitioner may make this reference if he or she chooses. However, it is recommended the reporting guidance in the GAS/A-133 AICPA Audit Guide be followed; thus, the reference to OMB Circular A-133 would not be included.

Is the Report on Compliance and on Internal Control over Financial Reporting Always Required?

Another question the auditor may face relates to whether the report on internal control over financial reporting and on compliance must be issued in instances where the financial statements and the auditor's report on the financial statements are issued for purposes other than to meet a Yellow Book (or single audit) requirement. There is no requirement to issue the reports on internal control over financial reporting and on compliance in these situations.

Yellow Book Only Engagements

The reports discussed in this section can also be used if only a Yellow Book audit (and not an OMB Circular A-133 audit) was performed, i.e., Yellow Book only audits.

Basis of Accounting

A question that often arises is whether *Government Auditing Standards* or OMB Circular A-133 requires the basic financial statements to be presented in accordance with generally accepted accounting principles (GAAP). The answer is no. (Paragraph 1.22 of the Yellow Book specifically recognizes the use of other bases of accounting.) It is common for governmental entities to use a prescribed basis of accounting that demonstrates compliance with the cash basis and budgets required by state law. It is also common for both governmental entities and nonprofit organizations to use the cash or modified cash basis. If the client prepares its financial statements in accordance with a comprehensive basis of accounting other than GAAP, the auditor is still required to express or disclaim an opinion and should follow the guidance in SAS No. 62. SAS No. 62 (AU 623) requires a report on OCBOA financial statements to include a paragraph that (a) states the basis of presentation and refers to the note to the financial statements that describes the basis, and (b) states that the basis of presentation is a comprehensive basis of accounting other than GAAP. (SAS No. 62 clarifies that the note, but not the report itself, should describe how the presentation differs from GAAP and that the effects of the difference need not be quantified.) The opinion paragraph expresses an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described. Although not required by OMB Circular A-133, it is believed the schedule of expenditures of federal awards should be prepared on the same basis of accounting as the financial statements if possible, since the auditor must state whether the schedule is presented fairly in all material respects in relation to the financial statements.

Noncompliance Findings

Fraud and illegal acts (except those that are inconsequential) and other noncompliance findings that are material to the financial statements must be reported in the Yellow Book report on internal control over financial reporting and on compliance and other matters. In addition to their effect on the internal control and compliance report, their effect *should be considered* when reporting on the basic financial statements. Generally, such findings, while they may be material to a specific federal program, are not material to the basic financial statements. This is especially true for governmental units such as cities and counties. However, in some instances, the effect of such findings can be material to the basic financial statements. These instances are more likely to occur for entities that rely on federal programs as their principal source of support.

When testing compliance with the compliance requirements, comply/noncomply judgments are necessary. When the judgment cannot be made because the auditor is unable to complete audit procedures the auditor considers necessary for making the decision, a scope limitation exists. When resolution of a noncompliance finding cannot be determined (and a scope limitation has not occurred), an uncertainty exists. The following paragraphs discuss in more detail the definition of an uncertainty, scope limitations, and uncertainty versus GAAP departure.

Scope Limitations

Limitations on the scope of the audit may be imposed by the client or by circumstances. GAAS requires auditors to modify their opinion if they are unable to apply all the procedures considered necessary. SAS No. 58 at AU 508.24 states that, ordinarily, the auditor should disclaim an opinion when restrictions that significantly limit the scope of the audit are imposed by the client.

Qualified Opinion Because of a Scope Limitation. When the auditor qualifies his or her opinion because of a scope limitation, SAS No. 58 at AU 508.25 requires that the situation causing a scope qualification be described in

an explanatory paragraph preceding the opinion paragraph and be referred to in both the scope and opinion paragraphs.

Disclaimer of Opinion Because of a Scope Limitation. In some cases, the auditor may assess the omitted procedure(s) as so important to his or her ability to form an opinion on the financial statements, and the nature, magnitude, and significance of the potential effects on the financial statements as so great, that he or she decides to disclaim an opinion. SAS No. 58 at AU 508.62 requires that, when the auditor disclaims an opinion, a separate paragraph should indicate all of the substantive reasons for the disclaimer, and the report should indicate that the scope of the work was not sufficient to warrant the expression of an opinion. Also, the entire scope paragraph describing the nature of an audit should be omitted. Even though the report disclaims an opinion on the financial statements taken as a whole, it should disclose any departures from GAAP of which the auditor is aware. It is believed that any inconsistencies the auditor is aware of should also be disclosed in the report.

A disclaimer of opinion may be necessary due to loss or destruction of an entity's accounting records. Both the AICPA and GAO have issued guidance on audit considerations when a client's records have been destroyed.

Uncertainties

Definition of an Uncertainty. SAS No. 58 (AU 508.29) describes an uncertainty as a matter that "is expected to be resolved at a future date, at which time conclusive audit evidence concerning its outcome would be expected to become available." When an uncertainty exists, it is not possible to determine whether the financial statements should be adjusted, or in what amount. This is often the case with noncompliance findings.

Scope Limitation. Auditors should consider issuing a qualified opinion because of a scope limitation if audit evidence concerning the uncertainty (including its possible outcome or a reasonable estimate of the amount of an uncertainty classified as "probable") exists or did exist but is not available for reasons such as unreasonable time constraints, lack of records, or a restriction imposed by management. An emphasis paragraph is not an appropriate substitute for a qualified opinion or disclaimer of opinion because of a scope limitation.

Uncertainty versus GAAP Departure. Uncertainties should not be confused with the dollar amount of estimates or accruals to which the auditor takes exception. For example, recognition of a federal award that is the subject of a noncompliance finding is appropriate only when (a) it is probable that the resolution of the finding will not result in an amount less than the amount recognized and (b) the amount can be reliably estimated. Auditors assess the likelihood that resolution of the finding will result in less federal award revenue than the amount recognized by considering whether the evidence supporting the finding is objective and verifiable and by reviewing the past history of how such findings were resolved. In rare instances, a legal opinion may be obtained stating whether there is a reasonable basis to support the organization's position.

When the auditor believes that it is not probable that an organization's position will result in receipt of the federal award revenue recognized, the GAAP requirements for recognition of the federal award are not met. SAS No. 58 (AU 508.48) states that if the auditor "concludes that the accounting principles used cause the financial statements to be materially misstated, he or she should express a qualified or an adverse opinion." The auditor should also issue a qualified or an adverse opinion if the financial statements do not adequately disclose matters involving an uncertainty.

Reporting When an Uncertainty Exists

Emphasis Paragraph. Previously, SAS No. 58 required in some instances an emphasis paragraph be added to the auditor's report. (An emphasis paragraph is explanatory language added to the auditor's report that does not affect the auditor's unqualified opinion.) SAS No. 79, *Amendment to Statement on Auditing Standards No. 58, "Reports on Audited Financial Statements,"* eliminated that requirement. However, SAS No. 79 does not prohibit emphasis paragraphs concerning uncertainties. Auditors may, accordingly, include an emphasis paragraph at their discretion.

When auditors determine that an unqualified opinion is appropriate, and *choose to include* an explanatory paragraph emphasizing that an uncertainty exists, the report should include the following:

- a. An introductory paragraph, scope paragraph, and an opinion paragraph identical to those in the standard report.
- b. An explanatory paragraph following the opinion paragraph of the report. The explanatory paragraph should describe the matter giving rise to the uncertainty and may indicate that its outcome cannot presently be determined.

The following is an example of an emphasis paragraph when an uncertainty exists as a result of a noncompliance finding:

As discussed in Note X to the financial statements, (name of governmental entity or nonprofit organization) failed to comply with certain requirements applicable to the federal programs in which it participates. The ultimate effect of the actions of the (describe entity) and federal agencies relative to these instances of noncompliance cannot presently be determined. Accordingly, no provision for any liability that may result upon resolution has been made in the accompanying financial statements.

The emphasis paragraph makes it clear that the effects of the noncompliance finding cannot presently be resolved because the outcome depends on future events. Some auditors include a statement in the emphasis paragraph stating that management believes that the outcome of the uncertainty will not have a material effect on the financial statements. The writers of this course do not agree with the practice, since such a statement is not required by, nor included in, any of the report examples in the authoritative literature. Statements of that nature could lead readers to believe that the auditors concur with management's belief.

Department, Agency, or Other Organizational Unit Financial Statements

A Yellow Book or single audit may cover an individual department, agency, or other organizational unit (including component unit) that receives federal awards. In those instances, the auditor's report on the financial statements should be revised to properly identify the entity as a department, agency, component unit, or other organizational unit.

Part of the Reporting Entity Does Not Have a Yellow Book Audit

As discussed in Paragraph 4.39 of the GAS/A-133 AICPA Audit Guide, in some cases the audit of a material portion of the reporting entity is not required to be and is not performed in accordance with *Government Auditing Standards* even though the audit of the reporting entity is required to be performed in accordance with *Government Auditing Standards*. In those instances the scope paragraph should be modified to include the following as the third sentence of the paragraph:

The financial statements of [**Government:** Name of Component Unit or Fund/**Nonprofit Organization:** Name of Affiliated Organization or Other Portion of the Reporting Entity] were not audited in accordance with *Government Auditing Standards*.

According to footnote 40 to Paragraph 4.40 of the GAS/A-133 AICPA Audit Guide, for audits of governmental entities, if it is not apparent 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.

Communicating Significant Matters

AU 508.19 provides examples of important matters, such as significant related party transactions or an unusual subsequent event, which auditors may wish to highlight with an explanatory paragraph in their report on the financial statements. Also, in response to public interest in the operations of entities that receive federal awards as well as in the entities that administer them, the Yellow Book provides guidance that encourages the auditor to communicate certain information beyond that described in generally accepted auditing standards. As stated in

Paragraph 5.23 of the Yellow Book, “. . . there may be situations in GAGAS audits in which certain types of information would help facilitate the readers' understanding of the financial statements and the auditors' report. These situations may be in addition to the examples presented in AICPA standards.”

While acknowledging that the decision about whether to communicate this information is a matter of professional judgment, the Yellow Book provides the following examples of the types of matters the auditor may communicate the following:

- Significant uncertainties or concerns about the fiscal sustainability of a government or program, or other matters that could have a significant impact on the financial condition or operations of the government entity *beyond one year of the financial statement date*.
- Unusual or catastrophic events that will likely have a significant ongoing or future impact on the entity's financial condition or operations.
- Significant uncertainties surrounding projections or estimations in the financial statements.
- Any other matter considered significant for communication to users and oversight bodies.

The Yellow Book states the communication may be presented in a separate paragraph or a separate section of the auditor's report and may include information that is not disclosed in the financial statements.

Confidential or Sensitive Information

The Yellow Book also provides guidance about the considerations auditors should use when reporting on the results of the audit and confidential or sensitive information is involved. If pertinent information is omitted from the report because it is prohibited from public disclosure or because it is confidential or sensitive, the auditor should disclose that fact and the reason or circumstances that make the omission necessary in the report. Additionally, the auditor may issue separate, classified, or limited-official-use reports.

At Paragraph 5.43, the Yellow Book points out that audit organizations themselves may be subject to public records laws. If so, auditors should determine, possibly with the help of legal counsel, whether this could impact the availability of classified or limited-official-use reports. The auditor should consider whether alternative means of communication with management and those charged with governance would be more appropriate. The Yellow Book suggests, for example, that auditors may communicate general information in a written report and detailed information verbally when confidential or sensitive information is involved.

Reporting on Restated Financial Statements

Both GAAS and *Government Auditing Standards* establish requirements for auditors who become aware of new information that could have affected their report on previously-issued financial statements.

GAAS Requirements. If auditors become aware of information that might have affected their opinion, GAAS (AU 561) requires auditors to advise management to determine the potential effect of the new information on the previously issued financial statements as soon as reasonably possible. If management determines that the financial statements were materially misstated and, as a result, the financial statements are restated and reissued, the auditor should advise management to make appropriate disclosure of the facts and their impact on the financial statements to those who are likely to rely on the financial statements.

Government Auditing Standards Requirements. *Government Auditing Standards*, at Paragraph 5.27, requires auditors to advise management to make appropriate disclosures when the auditor believes that (a) previously-issued financial statements are likely to be misstated and (b) the misstatement is or reasonably could be material. Auditors are also required to—

- Evaluate the timeliness and appropriateness of management's disclosure and actions to determine and correct misstatements in the previously-issued financial statements,

- Report on the restated financial statements, and
- Report directly to appropriate officials when the auditee does not take the necessary steps.

Evaluating the Timeliness and Appropriateness of Management's Disclosure and Actions. The Yellow Book, at Paragraph 5.28, states that auditors should evaluate whether management:

- Acted in an appropriate time frame after new information was available to determine the financial statement effects of the new information and notify those likely to rely on the financial statements.
- Disclosed the nature and extent of the known or likely material misstatements on web pages where management has published the auditors' report on the previously-issued financial statements.
- Disclosed the following in the restated financial statements:
 - Nature and cause of the misstatements.
 - Specific amounts of material misstatements.
 - Related effects on the previously-issued financial statements [for example, year(s) being restated, specific financial statements and line items restated, and actions management took after learning of the misstatement].
 - Impact on the financial statements as a whole, including key information in MD&A.

Report on Restated Financial Statements. The Yellow Book, at Paragraph 5.29, states that when financial statements are restated, "auditors should perform audit procedures sufficient to reissue or update the auditors' report on the restated financial statements regardless of whether the restated financial statements are separately issued or presented on a comparative basis with those of a subsequent period."

The auditors' report on reissued or updated financial statements should include an explanatory paragraph that includes:

- A statement that the previously-issued financial statements have been restated,
- A statement that (a) the previously-issued auditors' report (include report date) is not to be relied on because the financial statements were materially misstated and (b) the previously-issued auditors' report is replaced by the report on the restated financial statements,
- A reference to the note(s) to the financial statements that discusses the restatement, and
- If applicable, a reference to the report on internal control that discusses any significant internal control deficiency identified by the auditors as having failed to prevent or detect the misstatement and any related corrective action taken by management.

If management does not make appropriate disclosures, the auditors' report should also include the omitted disclosures. In addition, management's failure to include appropriate disclosures may have implications for the audit.

Reporting Directly to Appropriate Officials. If management does not act in an appropriate time frame or restate the financial statements with reasonable timeliness, the Yellow Book, at Paragraph 5.31, requires the auditor to notify those charged with governance about the situation. Those charged with governance should be informed that the auditors will take further steps to prevent reliance on the auditors' report. The auditors also should advise those charged with governance to notify oversight bodies and funding agencies that rely on the financial statements. If those charged with governance do not notify appropriate oversight bodies or funding agencies, the Yellow Book states that the auditor should do so. If this situation occurs, it is recommended that the auditor consider consulting with an attorney before making such notification.

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS REQUIRED BY GOVERNMENT AUDITING STANDARDS

An audit must be performed in accordance with *Government Auditing Standards* (Yellow Book) when required by law, regulation, contract, agreement, or policy. Many governmental unit and nonprofit organization audits are Yellow Book audits due to requirements in OMB Circular A-133 and the provisions of state law or grant contracts. As indicated at Exhibit 1-1 and Exhibit 1-2, *Government Auditing Standards* requires testing and reporting on internal control over financial reporting, and on compliance with laws, regulations, contracts, and grant agreements and other matters. The illustrative auditor's reports included in Chapter 4, Appendix A of the GAS/A-133 AICPA Audit Guide combine the reporting on internal control and on compliance and other matters required by *Government Auditing Standards* into a single report. Representatives of OMB have recommended that the Yellow Book report not be combined with the OMB Circular A-133 report.

Reporting on Internal Control

When providing an opinion or a disclaimer on financial statements, *Government Auditing Standards* require that auditors also report on internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements. This requirement can be accomplished within the report on the financial statements or in a separate report. If a separate report is issued, the auditor should include reference to the separate report in the report on financial statements. The GAS/A-133 AICPA Audit Guide recommends a separate report. Generally, the Yellow Book report on internal control and compliance should—

- Describe the scope of the auditor's testing of internal controls over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements.
- State whether the tests performed provide sufficient, appropriate evidence to support an opinion on the effectiveness of internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements.
- Describe the significant deficiencies, including identification of any significant deficiencies that individually or in the aggregate are considered to be material weaknesses, identified as a result of the audit work performed.

Government Auditing Standards requires the report on internal control to disclose significant deficiencies and material weaknesses in internal controls over financial reporting based on the audit of the financial statements. Accordingly, at Paragraphs 5.11 and 5.13, the Yellow Book states that the auditor should report all internal control deficiencies that are significant deficiencies, and all significant deficiencies (or combinations of significant deficiencies) that are considered to be material weaknesses. The Yellow Book adopts the internal control terminology and definitions of SAS No. 112, therefore the internal control deficiencies that are required to be reported under *Government Auditing Standards* are the same as those that are required to be reported according to SAS No. 112 (AU 325A). The Yellow Book also adopts the internal control communication requirements under SAS No. 112 (AU 325A); therefore, audits performed under *Government Auditing Standards* will meet the internal control communication requirements of SAS No. 112 (AU 325A).

If an auditor obtains sufficient, appropriate evidence that a significant deficiency has been remediated before the report is issued, that fact should also be included in the auditor's report.

The Yellow Book requires the auditor's standard report on internal control over financial reporting and compliance to include the following basic elements:

- A statement that the auditor has audited the financial statements of the entity, including a reference to the auditor's report on those financial statements and a description of any departures from the standard report.
- A statement that the audit was conducted 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.

- A statement that, in planning and performing the audit, the auditor considered the entity's internal control over financial reporting to determine the auditing procedures for the purpose of expressing an opinion on the financial statements (not to provide an opinion on the internal control over financial reporting) and, accordingly, the auditor does not express an opinion on the effectiveness of internal control over financial reporting.
- The definitions of *control deficiency* and *significant deficiency*.
- A statement that the auditor's consideration of internal control over financial reporting 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 certain deficiencies in internal control over financial reporting were identified that the auditor considers to be significant deficiencies.
- If significant deficiencies are identified, a description of those significant deficiencies along with any comments and planned corrective actions that responsible officials have indicated will be taken. (Alternatively, this information can be provided in a separate schedule. In this case, include a reference to this separate schedule.)
- The definition of a *material weakness*.
- If no *significant deficiencies* are identified, a statement that no *material weaknesses* were noted.
- If significant deficiencies are identified, 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 are material weaknesses.
- A statement that as part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, the auditor performed tests of the entity'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.
- A statement that providing an opinion on compliance with those provisions was not an objective of the audit and, accordingly, the auditor does not express such an opinion.
- 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* and, if so, describes the noncompliance or other matters (including the views of responsible officials and their planned corrective action) or refers to the separate schedule in which they are presented. Also, a statement that the auditor did not audit the entity's written response and, accordingly, expresses no opinion on it.
- A statement that additional matters were communicated in a management letter, if applicable.
- A separate, restricted use paragraph stating that the report is intended solely for the information and use of management, others within the entity, and other parties outside of the entity and is not intended to be and should not be used by anyone other than these specified parties. (Identify any management bodies, individuals charged with governance, and other specified parties.)
- The signature of the auditor's firm.
- The date of the auditor's report, which should agree with the date of the auditor's report on the financial statements.

When auditors report separately on internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements, the guidance for the required disclosures and references for the auditor's report on the financial statements should be followed.

GAO Interim Guidance on Reporting on Internal Control Over Financial Reporting Under SAS No. 115. In October 2008, the AICPA issued SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*, which supersedes SAS No. 112 (AU 325A) effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation of SAS No. 115 is permitted. SAS No. 115 revises the definitions of the terms *material weakness* and *significant deficiency* that had been established in SAS No. 112 and are included in the Yellow Book. In order to address the new GAAS requirements that will be effective when SAS No. 115 is implemented, in November 2008 the GAO issued interim guidance on implementing SAS No. 115 in a Yellow Book audit. That guidance states:

- Auditors can meet the Yellow Book's internal control reporting requirements by: including in their report on internal control all identified material weaknesses and significant deficiencies,
 - following the new definitions and requirements from SAS No. 115,
 - providing those definitions, and
 - describing the scope of testing performed on internal control over financial reporting.
- Auditors are reminded to comply with all other relevant Yellow Book requirements related to reporting deficiencies in internal control, such as:
 - developing findings and providing recommendations for corrective action,
 - obtaining views of responsible officials, and
 - ensuring appropriate report distribution.

The GAO's interim guidance cautions auditors that this issue will be fully deliberated in conjunction with the next Yellow Book update and may change at that time. Because the definitions in SAS No. 115 are easier to understand and apply, some audit firms may consider early adoption. It is generally recommended that auditors not implement SAS No. 115 before the required effective date, even for their Yellow Book-only engagements. The discussions about the report on internal control over financial reporting and on compliance and other matters required by *Government Auditing Standards* in this lesson do not reflect the changes to the definitions of control deficiencies in SAS No. 115.

Considerations for Implementing SAS No. 115 in Single Audits. Although GAO released interim guidance that enables auditors to early implement SAS No. 115 (AU 325) on Yellow Book audits, the AICPA Audit Risk Alert, *Government Auditing Standards and Circular A-133 Developments—2008*, Paragraph .80, cautions auditors that OMB Circular A-133 and other similar federal regulations or audit guides have not been updated to reflect new internal control definitions for reporting on internal control over compliance. The risk alert states that it would not be appropriate to use SAS No. 115 definitions for reporting on internal control over compliance until OMB Circular A-133 or other regulations or guides are amended to allow usage of new updated definitions. When this course went to press, such amendments had not yet been made and the AICPA had not yet developed illustrative reports that reflect the new internal control definitions in SAS No. 115. Auditors should monitor the AICPA's Governmental Audit Quality Center website at <http://gaqc.aicpa.org/> for release of report examples that use the SAS No. 115 internal control definitions.

The auditor's report on internal control over financial reporting and on compliance and other matters should include the audit findings or, if applicable, refer to a separate schedule that presents the findings. The Yellow Book states that when presenting audit findings such as deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse, auditors should develop the elements of the findings to the extent necessary to achieve the audit objectives. The auditor should use professional judgment when considering whether and how to communicate internal control deficiencies that have an inconsequential effect on the financial statements.

The Yellow Book, at Paragraph 5.08, indicates that auditors may, but are not required to, render an opinion on the effectiveness of internal control over financial reporting if sufficient work was performed. However, this course does

not recommend rendering an opinion on internal control because neither the AICPA nor GAO has issued standards on issuing an opinion in internal control in a financial audit.

Reporting on Compliance with Laws and Regulations

Government Auditing Standards require that, as part of a financial audit, transactions be tested for compliance with laws and regulations that may have a material effect on the financial statements. The Yellow Book requires reporting on compliance with laws and regulations that may have a material effect on the financial statements. Material instances of noncompliance must be disclosed. It requires a report that includes the following:

- 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.
- Findings of fraud and illegal acts, except for those that are inconsequential, and noncompliance or abuse that could have a material effect on the financial statements.
- A statement of whether the tests performed provide sufficient appropriate evidence to support an opinion on compliance.

The reporting thresholds differ for noncompliance related to fraud or an illegal act, and noncompliance related to breaches of a contract or grant agreement. Understandably, the threshold is set at a lower level (i.e., more than inconsequential) for reporting noncompliance related to fraud or an illegal act since those actions are generally the result of violations of laws or regulations. It is recommended that auditors exercise care to understand the nature of noncompliance—whether its source is statutory or a contract/grant provision—in order to apply the appropriate threshold. This may not always be a clear-cut decision; in some cases, the source may not be obvious. For example, some contract provisions may derive from a statutory source without explicitly referencing a law or regulation. Therefore, the auditor might need to communicate with various parties such as program administrators, grantors, pass-through entities, oversight agencies, and legal counsel to fully understand provisions of contracts or grant agreements.

Reporting Views of Responsible Officials

When deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse are reported, auditors should obtain and report the responsible officials' views concerning the auditor's reported findings, conclusions, and recommendations. The entity's planned corrective actions should also be reported. It is preferable if the response is provided in writing; if so, a copy of the auditee's comments, or a summary, should be included in the auditor's report. (It is believed that inclusion in the schedule of findings and questioned costs as required by OMB Circular A-133 is the equivalent of inclusion in the "auditor's report.") If the responsible officials provide their comments orally, the auditor should prepare a summary of the comments to verify that the comments are accurately stated. This summary should be included with the auditor's report.

The auditor is required to include an evaluation of the auditee's comments in the audit report. Therefore, the auditor should evaluate the comments and consider the impact on the audit reports. If the responses are inconsistent or in conflict with the auditor's findings, conclusions, or recommendations, or when planned corrective actions do not adequately address the auditor's recommendations, the reasons for any disagreement with the comments should be explained in the auditor's report.

The auditor's report may be issued without the views of responsible officials if the auditee refuses to provide comments or is unable to provide them on a timely basis. If this occurs, the auditor's report is required to indicate that the audited entity did not provide comments.

Illustrated Auditor's Reports

Report with No Reportable Instances of Noncompliance or Other Matters and No Material Weaknesses or Significant Deficiencies. Chapter 4, Appendix A, Example 4-3 of the GAS/A-133 AICPA Audit Guide, illustrate a report on internal control over financial reporting and on compliance and other matters based on an audit of the financial statements of a governmental unit and nonprofit organization, respectively, performed in accordance with

Government Auditing Standards. No reportable instances of noncompliance or other matters and no material weaknesses or significant deficiencies were identified during the audit. Explanations and considerations designed to assist the auditor in drafting and modifying the report for differing circumstances are included in notes at the end of each appendix.

Report with Reportable Instances of Noncompliance and Other Matters and Significant Deficiencies but No Material Weaknesses. Chapter 4, Appendix A, Example 4-5 of the GAS/A-133 AICPA Audit Guide, illustrate a report on internal control over financial reporting and on compliance and other matters based on an audit of the financial statements of a governmental unit and nonprofit organization, respectively, performed in accordance with *Government Auditing Standards*. Significant deficiencies (none of which were material weaknesses), reportable instances of noncompliance, and other matters were identified during the audit.

Report with Significant Deficiencies When Some Are Material Weaknesses. The Yellow Book requires identification of any conditions that are material weaknesses. When the auditor believes that some significant deficiencies noted are of such magnitude as to be considered material weaknesses, the report is the same as the report discussed at the paragraph above.

The 2007 Yellow Book, Paragraph 4.14, states that when developing potential audit findings such as deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse, auditors should develop the elements of criteria, condition, cause, and effect or potential effect that are relevant and necessary to achieve the audit objectives. Thus, the elements that are needed for a finding depend entirely on the objectives of the audit, and a finding or set of findings is complete to the extent that the audit objectives are satisfied. Although the elements should be developed with respect to audit objectives rather than with the goal of providing management recommendations, it is believed that properly developed and articulated findings assist management or oversight officials of the audited entity in understanding the need for taking corrective action.

Reporting When Material Noncompliance Findings Are Identified. Noncompliance findings should be included in the schedule of findings and questioned costs and referred to in the auditor's report on internal control over financial reporting and on compliance and other matters.

Reports on Basis of Accounting Other Than GAAP

Both governmental and nonprofit organizations may present their financial statements on a basis of accounting other than GAAP. For example, it is common for governmental entities to use a prescribed basis of accounting that demonstrates compliance with the cash basis and budgets required by state law. It is common for both governmental units and nonprofit organizations to use the cash or modified cash basis. In these instances, it is believed the auditor's Yellow Book report on compliance and internal control should be modified as follows:

- a. The standard report should be modified to identify the appropriate basis of accounting (i.e., cash basis) and to state that the basis is a comprehensive basis of accounting other than generally accepted accounting principles.
- b. The references to "generally accepted accounting principles" throughout the remainder of the reports should be replaced with appropriate references to the basis of accounting in use (e.g., "the cash basis of accounting").
- c. For state and local governments that prepare their financial statements in accordance with the requirements of a governmental regulatory body instead of in conformity with GAAP, the report may not include restrictive use language when the government, either voluntarily or upon specific request, distributes the financial statements to parties other than the regulatory agency.

Reports on Departments, Agencies, Component Units, or Other Organizational Units

Both governmental and nonprofit organizations may engage auditors to perform Yellow Book audits of departments, agencies, component units, or other organizational units. In those instances, it is believed the auditor's

Yellow Book report on internal control over financial reporting and on compliance and other matters should be modified as follows:

- a. The name of the audited entity in the reports should reflect the status of the entity. Examples are as follows:
 - We have audited the financial statements of the DEF Branch Office of ABC Organization (a nonprofit organization) as of . . .
 - We have audited the financial statements of the Municipal Airport fund of the City of X, State Y, as of . . .

Part of the Reporting Entity Does Not Have a Yellow Book Audit

If a material portion of the reporting entity (for example, a component unit or a fund) is not required to undergo an audit in accordance with *Government Auditing Standards*, the scope paragraph of the auditor's report on internal control over financial reporting and compliance and other matters should be modified to disclose that fact and identify that segment of the reporting entity. The report on compliance and on internal control over financial reporting should be modified to include the following in the scope paragraph(s):

The financial statements of [Government: Name of Component Unit or Fund/Nonprofit Organization: Name of Affiliated Organization or Other Portion of the Reporting Entity] were not audited in accordance with *Government Auditing Standards*.

According to footnote 40 to Paragraph 4.40 of the GAS/A-133 AICPA Audit Guide, for audits of governmental entities, if it is not apparent 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.

Introductory Report Paragraphs—Yellow Book Reporting

Government Auditing Standards require that for the auditor's standard report on internal control over financial reporting and on compliance and other matters report include a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements. Any departure from the standard report on the financial statements, including qualified or adverse opinions, disclaimers of opinion, and explanatory language, has to be described in the Yellow Book report. In the audit reports included in the GAS/A-133 AICPA Audit Guide, these disclosures are only required in the first paragraph of the report on internal control over financial reporting and on compliance and other matters required by the Yellow Book. The guidance in the following paragraphs may be useful when modifying the introductory paragraph of the Yellow Book report to meet the GAS/A-133 AICPA Audit Guide requirement to describe any departure from the standard report on the financial statements.

Comparative Financial Statements

The financial statements for nonprofit organizations are often comparative. Governmental unit financial statements are less likely to be comparative. In these instances, departures from the standard report that relate to the earliest year presented need not be disclosed. An exception to this statement would be when the single audit period covers both years. Although the financial statements may be comparative, the Yellow Book report usually covers compliance and internal control over financial reporting for only the most recent audit period.

Qualified Opinion—GAAP Departure

Examples of the statement that might be added to the introductory paragraph, when the opinion on the financial statements is qualified for GAAP departures, follow:

In our report, our opinion on the aggregate discretely presented component units was qualified because, as discussed in Note X to the financial statements, the financial statements do not include financial activities of the (identify the component unit omitted), which should be included as a discretely presented component unit in order for the financial statements to conform with generally accepted accounting principles.

In our report, our opinion on the financial statements was qualified because, as discussed in Note X to the financial statements, the organization does not record donated marketable securities as contributions until they are sold. As a result, certain securities held were not recorded at June 30, 20X1, as required by generally accepted accounting principles.

Qualified Opinion—Scope Limitation

An example of the modification to the introductory paragraph when the opinion on the financial statements is qualified for a scope limitation follows:

In our report on the financial statements, our opinion on the (describe the opinion unit affected by the qualification) was qualified because, as described in the fourth paragraph, we were unable to obtain sufficient documentation supporting the city's compliance with certain of the requirements of the Community Development Block Grant Program.

The last sentence of the introductory paragraph would also be modified as follows:

Except as discussed in the preceding sentence, 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.

Adverse Opinion

Examples of the statement that might be added to the introductory paragraph when the opinion on the financial statements is adverse follow:

In our report on the financial statements, we expressed an adverse opinion on the financial statements because (describe reason for adverse opinion).

In our report on the financial statements, we expressed an adverse opinion on the (describe the opinion unit affected by the adverse opinion) because (describe reason for adverse opinion).

Disclaimer of Opinion

An example of the modification to the introductory paragraph when an opinion was disclaimed on the financial statements is as follows:

The following sentence should follow the first sentence in the introductory paragraph:

We did not express an opinion on the financial statements because we were unable to satisfy ourselves concerning the organization's compliance with the requirements of certain of its federal grants.

The last sentence of the introductory paragraph would also be modified as follows:

Except as discussed in the preceding sentence, 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.

Other Auditors

An other auditor may be involved in the audit of the financial statements of an affiliated entity for inclusion in combined or consolidated financial statements, or, in the case of a governmental entity, may be involved in the audit of a component unit. When that is the case, the principal auditor should refer to SAS No. 1, section AU 543 (and related interpretations at AU 9543), for guidance on deciding whether he or she may appropriately report as the

principal auditor, on making use of the work of the other auditor, and on deciding whether to make reference to the other auditor. If the principal auditor's report on the financial statements refers to other auditors, the GAS/A-133 AICPA Audit Guide at Paragraph 4.43 states the principal auditor should acknowledge the involvement of other auditors in the report on internal control over financial reporting and compliance and other matters. The GAS/A-133 AICPA Audit Guide provides two reporting options in this circumstance: the *reference* and the *inclusion* options. Neither option makes the principal auditor responsible for the specific findings of other auditors. In the rare case the principal auditor would be required to refer to the other auditors' report, it is believed the reference option is the most practical choice.

The GAS/A-133 AICPA Audit Guide at Paragraph 4.47 provides guidance for reporting on internal control over financial reporting and compliance and other matters under the reference option. The principal auditor's report should refer to the report on the financial statements. It should identify the organizations, functions, or activities audited by the other auditors and state whether any of those audits were *not* performed under *Government Auditing Standards*. Under the reference option, the introductory paragraph should state that the results of the other auditors' audits are not included in the principal auditor's report on internal control over financial reporting and compliance and other matters. Examples of the modifications to the introductory paragraph if the principal auditors' report on the financial statements refers to other auditors using the reference option are as follows:

- The following sentence should follow the first sentence of the first paragraph:

Our report was modified to include a reference to other auditors.

- The following should be added at the end of the first paragraph:

Other auditors audited the financial statements of [Identify organization, function, or activity], as described in our report on [Name of Governmental Unit or Name of Nonprofit Organization]'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.

If the other auditors' audits were not performed under *Government Auditing Standards*, the end of the first paragraph should read:

Other auditors audited the financial statements of [Identify organization, function, or activity], as described in our report on [Name of Governmental Unit or Name of Nonprofit Organization]'s financial statements. The financial statements of [Identify organization, function, or activity] were not audited in accordance with *Government Auditing Standards*.

Explanatory Language

Examples of the statements that might be added to the introductory paragraphs describing explanatory comments and paragraphs included in the report on the financial statements are as follows:

Going Concern

Our report on the financial statements includes an explanatory paragraph describing conditions, discussed in Note X to the financial statements, that raised substantial doubt about the entity's ability to continue as a going concern.

Accounting Change

Our report on the financial statements includes an explanatory paragraph describing a change, discussed in Note X to the financial statements, in the organization's method of accounting for contribution pledges.

Other Comprehensive Bases of Accounting

Our report on the financial statements disclosed that, as described in Note X to the financial statements, the city prepares its financial statements on a prescribed basis of accounting that demonstrates compliance with the cash basis and budget laws of (name of state), which is a comprehensive basis of accounting other than generally accepted accounting principles.

Component Unit

Our report on the financial statements disclosed that the financial statements include only the financial activities of the primary government and that the financial activities of other component units that form the reporting entity are not included.

Other

Our report on the financial statements includes an explanatory paragraph that describes a \$60,000,000 bond offering issued subsequent to (date of financial statements).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. Which of the following compliance statements should be used when all applicable unconditional and presumptively mandatory Yellow Book requirements have been followed?
 - a. A modified generally accepted government auditing standards (GAGAS) compliance statement.
 - b. An unmodified GAGAS compliance statement.
18. The Yellow Book requires the auditor to include which of the following in his or her report when reporting on internal control?
 - a. An introductory paragraph, scope paragraph, and an opinion paragraph identical to those in the standard report.
 - b. Any deficiencies identified as a result of the audit work performed.
 - c. The scope of the auditor's testing of internal controls over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements.
 - d. A statement that the previously-issued financial statements have been restated.
19. Which of the following statements on reporting and evaluating internal control is most accurate?
 - a. According to the Yellow Book, auditors are required to render an opinion on the effectiveness of internal control over financial reporting.
 - b. Auditor's are encouraged to render an opinion on internal control.
 - c. Auditors should use professional judgment when considering how to communicate internal control deficiencies that have an inconsequential effect on the financial statements.
20. The Yellow Book requires the auditor's standard report on internal control over financial reporting and compliance to include all of the following basic elements **except**:
 - a. The definitions of material misstatement.
 - b. The auditor's firm signature.
 - c. A statement that no material weaknesses were found.
 - d. A statement that deficiencies in internal control over financial reporting are identified that the auditor considers significant.
21. When reporting on internal control over financial reporting of departments or component units this course states that the auditor's report should be modified in which of the followings ways?
 - a. Modify the report to identify the appropriate basis of accounting.
 - b. Replace all references to the basis of accounting in use with "generally accepted accounting principles" through out the remainder of the report.
 - c. Document the audited entity's name in the reports the same as the status of the entity.
 - d. Omit any restrictive use language when the government, either voluntary or upon specific request, distributes the financial statements to parties other than the regulatory agency.

22. Which of the following opinions is an example of a qualified opinion—scope limitation?

- a. "In our report, our opinion on the aggregate discretely presented component units was qualified because, as discussed in Note X to the financial statements, the financial statements do not include financial activities of the (identify the component unit omitted), which should be included as a discretely presented component unit in order for the financial statements to conform with generally accepted accounting principles."
- b. "In our report on the financial statements, we expressed an adverse opinion on the financial statements because"
- c. "We did not express an opinion on the financial statements because we were unable to satisfy ourselves concerning the organization's compliance with the requirements of certain of its federal grants."
- d. "In our report on the financial statements, our opinion on the (describe the opinion unit affected by the qualification) was qualified because, as described in the fourth paragraph, we were unable to obtain sufficient documentation supporting the city's compliance with certain of the requirements of the Community Development Block Grant Program."

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. Which of the following compliance statements should be used when all applicable unconditional and presumptively mandatory Yellow Book requirements have been followed? **(Page 323)**
- a. A modified generally accepted government auditing standards (GAGAS) compliance statement. [This answer is incorrect. A modified GAGAS compliance statement states either (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.]
 - b. **An unmodified GAGAS compliance statement. [This answer is correct. An unmodified GAGAS compliance statement states the audit was performed in accordance with Government Auditing Standards. This type of statement should be used in the audit report when: (1) all applicable unconditional and presumptively mandatory Yellow Book requirements have been followed, or (2) all unconditional requirements have been followed, and the justification for any departures from applicable presumptively mandatory requirements has been documented and the objectives of those requirements have been achieved through other means.]**
18. The Yellow Book requires the auditor to include which of the following in his or her report when reporting on internal control? **(Page 330)**
- a. An introductory paragraph, scope paragraph, and an opinion paragraph identical to those in the standard report. [This answer is incorrect. When auditors determine that an unqualified opinion is appropriate, and *choose to include* an explanatory paragraph emphasizing that an uncertainty exists, the report should include an introductory paragraph, scope paragraph, and an opinion paragraph identical to those in the standard report. This is necessary when reporting when an uncertainty exists.]
 - b. Any deficiencies identified as a result of the audit work performed. [This answer is incorrect. The auditor's report should include the significant deficiencies, including identification of any significant deficiencies that individually or in the aggregate are considered to be material weaknesses, identified as a result of the audit work performed.]
 - c. **The scope of the auditor's testing of internal controls over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements. [This answer is correct. The Yellow Book requires the auditor's report to also include a statement on whether the tests performed provide sufficient, appropriate evidence to support an opinion on the effectiveness of internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements; and the significant deficiencies, including identification of any significant deficiencies that individually or in the aggregate are considered to be material weaknesses, identified as a result of the audit work performed.]**
 - d. A statement that the previously-issued financial statements have been restated. [This answer is incorrect. Only the auditors' report on reissued or updated financial statements should include an explanatory paragraph that includes a statement that the previously-issued financial statements have been restated.]
19. Which of the following statements on reporting and evaluating internal control is most accurate? **(Page 332)**
- a. According to the Yellow Book, auditors are required to render an opinion on the effectiveness of internal control over financial reporting. [This answer is incorrect. The Yellow Book, at Paragraph 5.08, indicates that auditors may, but are not required to, render an opinion on the effectiveness of internal control over financial reporting if sufficient work was performed.]

- b. Auditor's are encouraged to render an opinion on internal control. [This answer is incorrect. The writer's of this course do not recommend rendering an opinion on internal control because neither the AICPA nor GAO has issued standards on issuing an opinion in internal control in a financial audit.]
 - c. **Auditors should use professional judgment when considering how to communicate internal control deficiencies that have an inconsequential effect on the financial statements. [This answer is correct. The auditor should use professional judgment when considering whether and how to communicate internal control deficiencies that have an inconsequential effect on the financial statements.]**
20. The Yellow Book requires the auditor's standard report on internal control over financial reporting and compliance to include all of the following basic elements **except: (Page 332)**
- a. **The definitions of material misstatement and material weakness. [This answer is correct. The Yellow Book requires auditors to include the definitions of significant deficiency, control deficiency, and material weakness in the standard report on internal control over financial reporting and compliance, but not material misstatement.]**
 - b. The auditor's firm signature. [This answer is incorrect. The signature of the auditor's firm should be included in the standard report on internal control over financial reporting and compliance.]
 - c. A statement that no material weaknesses were found. [This answer is incorrect. A statement that no material weaknesses were noted should be included in the standard report on internal control over financial reporting and compliance if no significant deficiencies were identified during the audit.]
 - d. A statement that specific deficiencies in internal control over financial reporting are identified that the auditor considers significant. [This answer is incorrect. If significant deficiencies are identified, a statement that certain deficiencies in internal control over financial reporting were identified that the auditor considers significant deficiencies should be included in the auditor's standard report on internal control over financial reporting and compliance.]
21. When reporting on internal control over financial reporting of departments or component units this course states that the auditor's report should be modified in which of the followings ways? **(Page 334)**
- a. Modify the report to identify the appropriate basis of accounting. [This answer is incorrect. It is common for both governmental units and nonprofit organizations to use the cash or modified cash basis. In these instances, this course suggests the auditor's Yellow Book report on compliance and internal control be modified by identifying the appropriate basis of accounting (i.e., cash basis) and state that the basis is a comprehensive basis of accounting other than generally accepted accounting principles.]
 - b. Replace all references to the basis of accounting in use with "generally accepted accounting principles" through out the remainder of the report. [This answer is incorrect. When an organization uses the cash or modified basis of accounting, this course suggests the auditor's Yellow Book report on compliance and internal control be modified by replacing all references to the basis of accounting in use with "generally accepted accounting principles" through out the remainder of the report.]
 - c. **Document the audited entity's name in the reports the same as the status of the entity. [This answer is correct. Both governmental and nonprofit organizations may engage auditors to perform Yellow Book audits of departments, agencies, component units, or other organizational units. In those instances, this course suggests the auditor's Yellow Book report on internal control over financial reporting and on compliance and other matters should be modified by listing the name of the audited entity in the reports to reflect the status of the entity.]**
 - d. Omit any restrictive use language when the government, either voluntary or upon specific request, distributes the financial statements to parties other than the regulatory agency. [This answer is incorrect. When an organization uses the cash or modified basis of accounting, this course suggests the auditor's Yellow Book report on compliance and internal control be modified by omitting restrictive use language when the government, either voluntarily or upon specific request, distributes the financial statements to parties other than the regulatory agency.]

22. Which of the following opinions is an example of a qualified opinion—scope limitation? **(Page 336)**

- a. "In our report, our opinion on the aggregate discretely presented component units was qualified because, as discussed in Note X to the financial statements, the financial statements do not include financial activities of the (identify the component unit omitted), which should be included as a discretely presented component unit in order for the financial statements to conform with generally accepted accounting principles." [This answer is incorrect. This is an example of a statement that might be added to the introductory paragraph, when the opinion on the financial statements is qualified for GAAP departures.]
- b. "In our report on the financial statements, we expressed an adverse opinion on the financial statements because." [This answer is incorrect. This is an example of a statement that might be added to the introductory paragraph when the opinion on the financial statements is adverse.]
- c. "We did not express an opinion on the financial statements because we were unable to satisfy ourselves concerning the organization's compliance with the requirements of certain of its federal grants." [This answer is incorrect. This is an example of a modification to the introductory paragraph when an opinion was disclaimed on the financial statements.]
- d. **"In our report on the financial statements, our opinion on the (describe the opinion unit affected by the qualification) was qualified because, as described in the fourth paragraph, we were unable to obtain sufficient documentation supporting the city's compliance with certain of the requirements of the Community Development Block Grant Program."** [This answer is correct. This is an example of the modification to the introductory paragraph when the opinion on the financial statements is qualified for a scope limitation.]

PREPARING AND REPORTING ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

As indicated at Exhibit 1-1 and Exhibit 1-2, OMB Circular A-133 requires, in addition to audited financial statements, a schedule of expenditures of federal awards. The auditee is responsible for the preparation of the schedule. This section discusses and illustrates the information that should be included in the schedule and discusses the auditor's report thereon.

State and local grantor agencies may also require the auditor to report on one or more similar schedules in accordance with their own single audit requirements. This discussion and the illustrations generally cover only the federal requirements, but the guidance may also be helpful in audits of the requirements of state and local grantor agencies.

Contents of the Schedule

Schedule Requirements. Exhibit 1-3 provides an example of the schedule. More examples are shown in Chapter 7 of Appendix A (at paragraph 7.22) of the GAS/A-133 AICPA Audit Guide, and other methods may be equally acceptable. The minimum requirements for a schedule from Section 310(b) of OMB Circular A-133 are listed below and are illustrated in Exhibit 1-3:

- a. The period covered by the schedule should be the same as that covered by the financial statements.
- b. The federal programs listed individually by federal agency. (Each federal award within a cluster of programs should be listed individually. When it is not practical to list each individual federal award for research and development, the total awards expended should be shown by federal agency and major subdivision within the federal agency.)
- c. The *Catalog of Federal Domestic Assistance* (CFDA) numbers or other identifying number when a CFDA number is not available. (See the CFDA listings at the CFDA website at www.cfda.gov.)
- d. For federal awards received by a subrecipient, the name of the pass-through entity and the identifying number assigned by the pass-through entity. (Though guidance is not clear in the Circular, it is believed the name of the federal agency and the CFDA number should also be included.)
- e. Note(s) describing the significant accounting policies used in preparing the schedule. [These notes are separate from the notes to the financial statements. They may be included directly on the schedule or on a separate page(s).]
- f. Total amount provided to subrecipients from each federal program. (This applies only to pass-through entities. The Circular indicates this information should be provided "to the extent practical.")
- g. The total federal awards expended during the period for each program (for each CFDA No. or other identifying number when the CFDA information is not available). (Though guidance is not clear in the Circular, it is believed the total awards expended should also be included as illustrated in Appendix A to Chapter 7 of the GAS/A-133 AICPA Audit Guide.)
- h. The value of the 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. (The Circular indicates that inclusion in the schedule is preferable but that the information may also be included in notes to the schedule.)

[Federal noncash assistance such as free rent, interest subsidies, food stamps, food commodities, Women/Infant/Children (WIC) program vouchers, or donated property may be shown in either the schedule or notes to the schedule and valued at fair market value at the time of receipt. WIC program vouchers may be valued at either maximum allowed redemption value or average redeemed value. Free rent by itself—when the entity has no other federal awards—is not considered a federal assistance and does not require a single audit (OMB *Questions and Answers on OMB Circular A-128*, question no. 33; PCIE Position Statement No. 6, question no. 29; included in *PPC's Government Documents Library* at Gov. Doc. Nos. 15 and 12, respectively).]

Exhibit 1-3**Schedule of Expenditures of Federal Awards**

ABC Organization
Schedule of Expenditures of Federal Awards
for the Year Ended June 30, 20X1^a

Federal Grantor/Pass-through Grantor/Program or Cluster Title^b	Federal CFDA Number^{b, c}	Pass-through Entity Identifying Number^d	Federal Expenditures
U.S. Department of Health and Human Services:			
Direct programs:			
Head Start	93.600		\$ 437,800
Runaway and Homeless Youth	93.623		125,000
Total direct programs			<u>562,800</u>
Pass-through programs from:			
State Department of Human Services:			
Community Services Block Grant (NOTE B)	93.569	K1578	536,000
Foster Care—Title IV-E	93.658	K1783	350,000
Total pass-through programs			<u>886,000</u>
Total U.S. Department of Health and Human Services			<u>1,448,800</u>
U.S. Department of Justice:			
Pass-through program from State Department of Justice—Victims of Child Abuse	16.547	N-123	<u>125,000</u>
U.S. Department of Agriculture:			
Pass-through program from State Child Food Program—Food Donation (NOTE C)	10.550	88888	<u>122,830</u>
Research and development cluster:			
U.S. Department of Health and Human Services:			
Direct programs:			
National Institute of Health (NOTE B)	N/A		475,000
Administration on Aging	N/A		225,000
Total direct programs			<u>700,000</u>
Pass-through programs from:			
Public Hospital—Heart Research	N/A	548-7	300,000
State Health Department—Food Safety Research	N/A	SB 573	100,000
Total pass-through programs			<u>400,000</u>
Total research and development cluster			<u>1,100,000</u>
Total expenditures of federal awards			<u>\$ 2,796,630</u>

See accompanying notes to schedule of expenditures of federal awards.

ABC Organization
Notes to Schedule of Expenditures of Federal Awards
for the Year Ended June 30, 20X1

NOTE A—BASIS OF PRESENTATION^e

The accompanying schedule of expenditures of federal awards includes the federal grant activity of ABC Organization and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

NOTE B—SUBRECIPIENTS^f

The ABC Organization provided federal awards to subrecipients as follows:

<u>Program Title</u>	<u>Federal CFDA Number</u>	<u>Amount Provided</u>
Community Services Block Grant	93.569	\$ 50,000
National Institute of Health	N/A	<u>75,000</u>
		<u>\$ 125,000</u>

NOTE C—FOOD DISTRIBUTION

Nonmonetary assistance is reported in the schedule at the fair market value of the commodities received and disbursed. At June 30, 20X2, the organization had food commodities totaling \$18,850 in inventory.

Notes:

- ^a To meet state or other requirements, an auditee may include nonfederal awards. If nonfederal awards are included, they should be segregated and clearly designated as nonfederal. The title of the schedule should be modified accordingly. As an alternative method, nonfederal awards may be included in a separate schedule.
- ^b These grants and CFDA numbers and other information, when prepared, were based on an actual schedule. This course has not verified the continued applicability of the information.
- ^c If the CFDA number is not available, the auditee should indicate that the CFDA number is not available and include in the schedule the program's name and, if available, other identifying number.
- ^d When pass-through awards are received, the identifying number assigned by the pass-through entity should be included in the schedule.
- ^e This note meets the Circular A-133 requirement to disclose the significant accounting policies used in preparing the schedule.
- ^f This information may also be included on the face of the schedule.

* * *

Schedule May Not Agree with Other Federal Award Reports. Paragraph 7.12 of the GAS/A-133 AICPA Audit Guide alerts auditors that the information included in the schedule may not fully agree with other reports on federal awards that the government has submitted to federal granting agencies. For example, the information may not agree because it was prepared for a different fiscal period or includes cumulative information. It is recommended that auditors consider the differences when planning and performing the single audit.

Major Program Designation. This course recommends that the schedule of expenditures of federal awards not indicate which programs are major programs because the auditor, not the auditee, performs the determination of major programs. However, a list of major programs must be included in the schedule of findings and questioned costs.

Optional but Recommended Information. As a general rule, the more information provided in the schedule, the fewer the follow-up calls from federal agencies. Federal officials prefer that the following information be included even though it is not technically required. In some instances, federal or other officials may actually request all of part of this additional information, although OMB Circular A-133 does not obligate the auditee to comply. In other instances, officials may request information not on this list.

- a. While the same program (e.g., same CFDA number) from different program years may be combined and reported on one line, where feasible, presenting each program year separately makes the schedule more useful to grantors [OMB Circular A-133, Sec. 310(b)].

- b. The financial information for the schedule should be taken from the entity's books, records, and financial statements. The amounts, however, may not agree with the amounts in the Federal Financial Status Reports (FSR). In some instances, it may be desirable to include a note to the schedule reconciling to the amounts shown in the FSRs (past practice).
- c. Any interest subsidy or administrative cost allowance received by the audited entity under a federal loan or loan guarantee program should be included in the schedule (*OMB Questions and Answers on OMB Circular A-128*, question no. 33; PCIE Position Statement No. 6, question no. 29).
- d. While its inclusion is not required by federal guidelines, nonfederal information, including nonfederal expenditures, may be included in the schedule. *When nonfederal information is included*, the federal and nonfederal information should be presented separately and appropriately labeled. Often, nonfederal information can be conveniently included in a note to the schedule or in a separate schedule (past practice).
- e. Expenditures may exceed awards when additional nonfederal sources provide support not required by the award. In these instances, the federal portion of the expenditures should be separately identified. The nonfederal expenditures may also be disclosed, preferably in a note to the schedule. When the nonfederal portion represents additional amounts the entity plans to bill a federal program, the amount and circumstances concerning the excess should be disclosed in a note to the schedule (PCIE Position Statement No. 6, question no. 36).
- f. When a pass-through entity is unable or unwilling to identify the federal portion of a contract or grant agreement, the subrecipient should report the entire amount as federal funds and indicate in a note to the schedule that the federal portion is not determinable. This course also suggests the note include, to the extent known, an explanation of why the amount is not determinable (*OMB Questions and Answers on OMB Circular A-128*, question no. 38; PCIE Position Statement No. 6, question no. 55).
- g. If the CFDA number is not known, the entity should include in the schedule or a note to the schedule the name of the awarding agency and the program. If the program name is not available, provide known information that will aid the agency in identifying the program. (PCIE Position Statement No. 6, question no. 40). Also, this course suggests following the guidance in the instructions to the data collection form (item 9) when the CFDA number is not available.
- h. Other suggested information for the schedule (PCIE Position Statement No. 6, question no. 29) includes the following:
 - (1) Amount of the program award and time period of the award.
 - (2) Matching contributions.
 - (3) Receipts or revenue recognized.
 - (4) Beginning and ending balances, such as unexpended amounts or accrued (deferred) revenue.
 - (5) Individual contract and grant numbers and amounts.
 - (6) Program income.

Common Deficiencies in the Schedule of Expenditures of Federal Awards. Peer reviews, as well as inspections by the AICPA professional ethics division and federal offices of inspectors general, have all identified problem areas and potential audit deficiencies related to the schedule of expenditures of federal awards, including the following:

- The schedule did not indicate whether awards were direct or pass-through.
- The schedule had inadequate notes (and sometimes no notes).
- Notes to the schedule did not disclose the basis of accounting used.

- The audit documentation did not indicate what procedures were performed relating to the schedule of expenditures of federal awards.
- The auditor's report failed to mention:
 - Improper accounting for restricted funds.
 - Omission of large federal programs (especially noncash awards) from the schedule.

The Report on the National Single Audit Sampling Project also noted deficiencies in the presentation and auditing of the schedule of expenditures of federal awards. The Report listed the omission of the following required items from some of the schedule of expenditures of federal awards reviewed during the project:

- The subgrant awards numbers assigned by pass-through entities were not included in the schedule.
- The names of pass-through entities, grantor federal agencies, or grantor federal agency names were missing.
- Multiple lines for CFDA numbers were shown, but the total expenditures for the CFDA number was not included.
- The programs that were parts of a cluster were not shown as such.
- The notes to the schedule were missing.
- The correct CFDA number was not reported.
- Research and Development (R&D) programs were not identified as such.

The Report also noted deficiencies in documentation of the auditor's testing of the schedule of expenditures of federal awards.

It is recommended that auditors should consider the deficiencies discussed in the previous paragraphs when conducting and reporting on audits of the schedule of expenditures of federal awards.

Student Financial Aid Programs. Schedule presentation guidelines for student financial aid (SFA) programs in OMB Circular A-133 audits recommended by PCIE Position Statement No. 6, question no. 29, include the following:

- a. Federal officials prefer that each individual SFA program be listed by CFDA number. If each program cannot be listed, totals by federal agency should be provided. More specific identification is needed because—
 - (1) The names of the respective federal agencies are needed to identify the agencies that are to receive copies of the reports and to allow the agencies to properly distribute the reports within their organizations.
 - (2) Individual agencies providing assistance need to verify that their funds were audited.
 - (3) Federal agencies may have close-out or other audit responsibilities making it necessary that they have detailed information about each program.
 - (4) The Bureau of Census, Federal Audit Clearinghouse plans to use the schedules to compile federal assistance by CFDA number.
- b. For loan programs, include any interest subsidy, administrative costs, or other expenses paid from federal funds to the audited institution.
- c. Include in the schedule or disclose in a note to the schedule the value (loan amount) of new student loans made by the institution during the audit period plus the balance of federal loans made in prior periods.

- d. Disclose in a note to the schedule the amount of new Federal Family Education Loan Program loans not made by the institution but which were received by students of the institution during the audit period. Interest subsidies and other costs related to these loans should not be listed on the schedule since these amounts go to the lender and not the institution.

Basis of Accounting

The basis of accounting to be used in the preparation of the schedule of expenditures of federal awards is not prescribed by OMB Circular A-133. Paragraph 7.05 of the GAS/A-133 AICPA Audit Guide indicates that the schedule may be prepared on a different basis of accounting from that in the financial statements. If possible, it is believed that the schedule of expenditures of federal awards should be prepared on the same basis as the financial statements since the auditor must state whether the schedule is presented fairly in all material respects in relation to the financial statements. However, Paragraph 7.09 notes that "in any case, the auditee should disclose the basis of accounting and the significant accounting policies used in preparing the schedule." Also, while the auditee must be able to reconcile amounts in the financial statements to related amounts in the schedule, such reconciliation is not required to be reported or submitted.

Even though OMB Circular A-133 does not prescribe the basis of accounting, it does state that determination of when an award is expended should be based on when the activity related to the award occurs. Exhibit 1-4 provides guidance for determining when different types of federal awards are expended.

Exhibit 1-4

Basis for Determining When Federal Awards Are Expended

Federal Awards	Basis for Determining When Expended
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
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

[SOURCE: AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits*, Table 7-1.]

* * *

Illustrated Disclosures. The following paragraphs illustrate certain of the optional but recommended disclosures. Other methods of disclosure may also be equally acceptable including disclosure on the face of the schedule.

An example of a note disclosing expenditures exceeding contract or grant award amount follows:

NOTE XX—(NAME OF GRANT)

Expenditures on the (name of project) exceeded the award amount by \$131,000. The excess, which is not included in the expenditure amount on the accompanying schedule of expenditures of federal awards, was (explain reason for excess cost). The (name of entity) plans to bill the (name of grantor) for the excess (explain why the amount should be billed to the grantor).

An example disclosure of program income is as follows:

NOTE XX—(NAME OF GRANT)

In accordance with terms of the grant, program income totaling \$45,000 was used to reduce the amount of federal funds used to complete the project.

Following is an example note disclosing circumstances when the pass-through entity cannot or will not provide the subrecipient with the amount of federal funds included in a contract or grant that includes both federal and other funds:

NOTE XX—(NAME OF GRANT)

During the year ended (date), funds totaling \$190,000 were received from (name of grantor—often a state department). While the grant agreement indicates that the source of the funds includes both federal (CFDA XX.XXX) and state awards, the (grantor) has not provided the organization with the amount of federal funds included. Because the federal portion of the expenditures is unknown, the full amount is included in the accompanying schedule of expenditures of federal awards.

An example of a note reconciling contract or grant amounts per the schedule to the amounts reported on the Federal Financial Status Report (FSR) follows:

NOTE XX—(NAME OF GRANT)

The grantee reports its receipts and expenditures to the (Name of Government Grantor) on a 12-month grant period that ends on March 31. A schedule reconciling the receipts and expenditures per the accompanying schedule of expenditures of federal awards to the Federal Financial Status Reports (FSR) for the year ended March 31, 20X1, is as follows:

	<u>Receipts</u>	<u>Expenditures</u>
Amount per schedule of expenditures of federal awards	\$ 383,420	\$ 383,420
Add amounts for the three months ended June 30, 20X0	94,000	92,628
Less amounts for the three months ended June 30, 20X1	<u>(97,420)</u>	<u>(97,628)</u>
Amounts per the March 31, 20X1 FSR	<u>\$ 380,000</u>	<u>\$ 378,420</u>

A note disclosing student financial aid programs follows:

NOTE XX—STUDENT FINANCIAL AID

The hospital administers a Health Professions Student Loan Program (CFDA No. 93.342) funded by the U.S. Department of Health and Human Services. At June 30, 20X2, the loans receivable balance for the program totaled \$618,629. Total program disbursements under the program for the year ended June 30, 20X2, follows:

	<u>Amount</u>
Student loans	\$ 123,423
Administrative cost allowances	18,513
Interest subsidies	<u>6,171</u>
	<u>\$ 148,107</u>

Accumulating Information for the Schedule

The requirement to present a schedule of expenditures of federal awards means that the recipient should identify all of its federal programs (direct and indirect, major and nonmajor) and related awards expended identified. Paragraph 7.08 of the GAS/A-133 AICPA Audit Guide states the auditor must evaluate internal control deficiencies that are identified in relation to the auditee's ability to prepare a complete and accurate schedule of expenditures of federal awards. When internal control deficiencies are identified, the auditor should determine whether those deficiencies individually or in combination, are significant deficiencies or material weaknesses relating to internal control over financial reporting, internal control over compliance, or both.

Reporting on the Schedule of Expenditures of Federal Awards

Section 505(a) of OMB Circular A-133 indicates that the auditor's report must include an opinion (or 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." This requirement is referring to an "in relation to opinion" on supplementary information based on SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor—Submitted Documents* (AU 551). According to SAS No. 29, the information is not a required part of the basic financial statements but is presented for purposes of additional analysis, and the auditor's opinion on the information concerns whether it is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Basic Requirements. AU 551.06 gives the following basic requirements for a SAS No. 29 report on additional information accompanying the basic financial statements in an auditor-submitted document:

- a. The report should state that the audit has been made for the purpose of forming an opinion on the basic financial statements taken as a whole.
- b. The report should identify the accompanying information. (Identification may be by descriptive title or page number of the document.)
- c. The report should state that the accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements.
- d. The report should include either an opinion on whether the accompanying information is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to the auditing procedures applied in the audit of the basic financial statements. (Generally, reports that disclaim an opinion will not satisfy the requirement for a single audit when the scope limitation causing the disclaimer is imposed by the client. That is, the disclaimer can be removed by applying additional audit procedures.)

The GAS/A-133 AICPA Audit Guide recommends combining the reporting on the schedule of expenditures of federal awards with other reports. However, a separate SAS No. 29 report on the schedule may be issued.

Illustrated Reporting. As recommended in Paragraph 12.12 of the GAS/A-133 AICPA Audit Guide, the illustrative auditor's reports in the GAS/A-133 AICPA Audit Guide combine the report on the schedule of expenditures of federal awards with the report on the financial statements. If the schedule is not presented with the financial statements (for example, a separate single audit package is issued), the required SAS No. 29 reporting on the schedule may be combined with the report on compliance and on internal control required by OMB Circular A-133, as illustrated in the GAS/A-133 AICPA Audit Guide.

Modified Auditor's Report. If the auditors' procedures lead them to believe that any of the schedule information is materially misstated in relation to the basic financial statements taken as a whole, they should discuss their reservations with the client and propose that the information be corrected. If their client refuses to revise the information, the auditors should issue either a qualified or adverse report on the schedule, depending upon the circumstances.

When auditors express a qualified opinion on the basic financial statements, they should consider the effect of that qualification on the schedule of expenditures of federal awards. If the auditor's report on the schedule is included in a separate section of the document, the report should refer to the qualification. If the qualification results from matters that also affect the information in the schedule, the auditor's reporting on the schedule should be appropriately qualified.

Qualified Auditor's Report for a Scope Limitation. When the opinion on the basic financial statements has been qualified because of a restriction on the scope of the audit (whether imposed by the client or by circumstances), and the restriction affects the schedule of expenditures of federal awards, the reporting on the schedule should be qualified accordingly.

Modified Auditor's Report for a Going Concern Uncertainty. It is believed that when the auditor's report on the basic financial statements has been modified because of a going concern uncertainty and that uncertainty affects the schedule of expenditures of federal awards, the auditor's reporting on the schedule should refer to the uncertainty and should use the phrases "substantial doubt" and "going concern."

Adverse Opinion or Disclaimer of Opinion on Basic Financial Statements. When auditors express an adverse opinion or disclaim an opinion on the basic financial statements, they should not express an opinion on the schedule of expenditures of federal awards. As explained in SAS No. 29 (AU 551.10), expressing an opinion in those circumstances might tend to overshadow or contradict the adverse opinion or disclaimer of opinion on the basic financial statements.

Reporting on a Basis of Accounting Other Than GAAP. Both governmental and nonprofit organizations may present their financial statements on a basis of accounting other than GAAP. Paragraph 12.10 of the GAS/A-133 AICPA Audit Guide requires auditees to disclose the basis of accounting and significant accounting policies used in preparing both the financial statements and the schedule of expenditures of federal awards. The auditor's reporting on the schedule should be modified when the basic financial statements and the schedule are on a basis of accounting other than GAAP or the basic financial statements and the schedule are on different bases of accounting.

Communicating Significant Matters. Auditors should consider the professional requirements when evaluating significant matters that may arise during the audit of the schedule of expenditures of federal awards. In addition to assessing whether matters identified during the audit constitute internal control deficiencies, auditors should consider the additional guidance about reporting significant matters beginning at Paragraph 5.23 of the Yellow Book.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. Which of the following statements regarding reporting on the schedule of expenditures of federal awards is accurate?
- a. All federal awards within a cluster of programs should be individually listed.
 - b. Note(s) describing significant accounting policies used in preparing the schedule should be include in the financial statements.
 - c. The period covered by the schedule may vary from that covered by the financial statements.
24. Which of the following is considered optional information in the schedule of expenditures of federal awards?
- a. Notes to the schedule.
 - b. Identified research and development programs.
 - c. Federal portion of expenditures are identified separately on the schedule.
 - d. Total expenditures for the CFDA number.
25. Which of the following is a true statement regarding the basis of accounting?
- a. Paragraph 7.09 of the GAS/A-133 AICPA Audit Guide states that determination of when an award is expended should be based on when the expenditure occurs.
 - b. Paragraph 7.09 of the GAS/A-133 AICPA Audit Guide indicates that the auditee is required to report all reconciled amounts in the financial statements to related amounts in the schedule.
 - c. When possible, the schedule of expenditures of federal awards should be prepared on the same basis as the financial statements.
 - d. The OMB Circular prescribes the basis of accounting to be used in the preparation of the schedule of expenditures of federal awards.
26. What is a SAS 29 report?
- a. An 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.
 - b. An opinion on the effectiveness of internal control over financial reporting.
 - c. A qualified opinion due to a scope limitation.
 - d. An opinion that expresses an adverse opinion or disclaimer of opinion on the basic financial statements.
27. When the auditor's report on the basic financial statements has been modified because of a going concern uncertainty and that uncertainty affects the schedule of expenditures of federal awards, the auditor reporting on the schedule should refer to the uncertainty and should use which of the following phrases?
- a. "Substantial doubt."
 - b. "Direct and material effect."
 - c. "Negative findings."

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. Which of the following statements regarding reporting on the schedule of expenditures of federal awards is accurate? **(Page 344)**
- a. **All federal awards within a cluster of programs should be individually listed. [This answer is correct. The federal programs are listed individually by federal agency. (Each federal award within a cluster of programs should be listed individually. When it is not practical to list each individual federal award for research and development, the total awards expended should be shown by federal agency and major subdivision within the federal agency.)]**
 - b. Note(s) describing significant accounting policies used in preparing the schedule should be include in the financial statements. [This answer is incorrect. Notes describing the significant accounting policies used in preparing the schedule are notes are separate from the notes to the financial statements. They may be included directly on the schedule or on a separate pages.]
 - c. The period covered by the schedule may vary from that covered by the financial statements. [This answer is incorrect. The period covered by the schedule should be the same as that covered by the financial statements.]
24. Which of the following is considered optional information in the schedule of expenditures of federal awards? **(Page 346)**
- a. Notes to the schedule. [This answer is incorrect. Notes to the schedule are a required item that must be included in the schedule of expenditures of federal awards.]
 - b. Identified research and development programs. [This answer is incorrect. All research and development programs must be identified in the schedule as such.]
 - c. **Federal portion of expenditures are identified separately on the schedule. [This answer is correct. Expenditures may exceed awards when additional nonfederal sources provide support not required by the award. In these instances, the federal portion of the expenditures should be separately identified. However, this is not considered a requirement.]**
 - d. Total expenditures for the CFDA number. [This answer is incorrect. If multiple lines for CDFA numbers are shown, the total expenditures for the CFDA numbers must be included.]
25. Which of the following is a true statement regarding the basis of accounting? **(Page 349)**
- a. Paragraph 7.09 of the GAS/A-133 AICPA Audit Guide states that determination of when an award is expended should be based on when the expenditure occurs. [This answer is incorrect. OMB Circular A-133 states that determination of when an award is expended should be based on when the activity related to the award occurs.]
 - b. Paragraph 7.09 of the GAS/A-133 AICPA Audit Guide indicates that the auditee is required to report all reconciled amounts in the financial statements to related amounts in the schedule. [This answer is incorrect. While the auditee must be able to reconcile amounts in the financial statements to related amounts in the schedule, such reconciliation is not required to be reported or submitted.]
 - c. **When possible, the schedule of expenditures of federal awards should be prepared on the same basis as the financial statements. [This answer is correct. If possible, it is believed that the schedule of expenditures of federal awards should be prepared on the same basis as the financial statements since the auditor must state whether the schedule is presented fairly in all material respects in relation to the financial statements.]**

- d. The OMB Circular prescribes the basis of accounting to be used in the preparation of the schedule of expenditures of federal awards. [This answer is incorrect. The basis of accounting to be used in the preparation of the schedule of expenditures of federal awards is not prescribed by OMB Circular A-133. Paragraph 7.09 of the GAS/A-133 AICPA Audit Guide indicates that the schedule may be prepared on a different basis of accounting from that in the financial statements.]

26. What is a SAS 29 report? (Page 351)

- a. **An 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.** [This answer is correct. Section 505(a) of OMB Circular A-133 indicates that the auditor's report must include an opinion (or 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."]
- b. An opinion on the effectiveness of internal control over financial reporting. [This answer is incorrect. Government Auditing Standards require that the auditor state whether the tests performed provide sufficient, appropriate evidence to support an opinion on the *effectiveness* of internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts and grant agreements. This opinion is not referred to as a SAS 29 report.]
- c. A qualified opinion due to a scope limitation. [This answer is incorrect. When the auditor qualifies his or her opinion because of a scope limitation, SAS No. 58 requires that the situation causing a scope qualification be described in an explanatory paragraph preceding the opinion paragraph and be referred to in both the scope and opinion paragraphs.]
- d. An opinion that expresses an adverse opinion or disclaimer of opinion on the basic financial statements. [This answer is incorrect. When auditors express an adverse opinion or disclaim an opinion on the basic financial statements, they should not express an opinion on the schedule of expenditures of federal awards. According to SAS No. 29, expressing an opinion in those circumstances might tend to overshadow or contradict the adverse opinion or disclaimer of opinion on the basic financial statements.]

27. When the auditor's report on the basic financial statements has been modified because of a going concern uncertainty and that uncertainty affects the schedule of expenditures of federal awards, the auditor reporting on the schedule should refer to the uncertainty and should use which of the following phrases? (Page 352)

- a. **"Substantial doubt."** [This answer is correct. The phrases "substantial doubt" and "going concern" should be used when the auditor's report on the basic financial statements has been modified because of a going concern uncertainty and that uncertainty affects the schedule of expenditures of federal awards.]
- b. "Direct and material effect." [This answer is incorrect. The phrase direct and material effect generally means that noncompliance *could* result in being denied reimbursement of program expenditures or having to refund federal monies or make other restitution in an amount that would be material to a major federal program.]
- c. "Negative findings." [This answer is incorrect. If the auditor discovers that a recipient could have been reimbursed for more than was claimed, a "negative" finding should be reported.]

REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY OMB CIRCULAR A-133

As indicated at Exhibit 1-1 and Exhibit 1-2, an audit performed in accordance with OMB Circular A-133 (single audit) must include additional reporting on compliance and on internal control in addition to the reporting required by the Yellow Book. The illustrative auditor's reports included in the GAS/A-133 AICPA Audit Guide combine the reporting on compliance and on internal control required by OMB Circular A-133 into a single report. However, representatives of OMB have recommended that the Circular A-133 report not be combined with the Yellow Book report.

The "Single Audit Reports Checklist Required by *Government Auditing Standards* and OMB Circular A-133" includes the OMB Circular A-133 report on compliance and on internal control over compliance as well as the Yellow Book reports on internal control over financial reporting and on compliance and other matters. The checklist can be used either to locate reporting guidance relevant to a particular situation or as a quality control check for draft reports before they are issued.

SAS No. 112 Considerations for Single Audits

Both the OMB and the AICPA issued guidance in 2007 addressing the applicability of SAS No. 112 (AU 325A) to single audits. In June 2007, OMB Circular A-133 was revised to require auditors to use terminology consistent with SAS No. 112 when reporting on internal control over compliance related to major federal award programs. The AICPA concurrently issued Interpretation No. 1 of SAS No. 112, *Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit* (AU 9325A.01), to establish the new internal control definitions that are applicable when the auditor is reporting on internal control over compliance in a single audit.

AU 9325A.01 provides the following definitions of control deficiencies applicable in a single audit:

- **Significant Deficiency:** 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.
- **Material Weakness:** 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.

The definitions in AU 9325A.01 are similar to those relating to internal control matters noted in a financial statement audit but focus on the objective of reporting on internal control over major program compliance. Similar to the original SAS No. 112 internal control deficiency definitions, the difference between a significant deficiency and a material weakness is the magnitude of the noncompliance that could have occurred. If the magnitude is more than inconsequential but less than material, the significant deficiency is not considered to be a material weakness. However, if the noncompliance would have been material to the federal program, the significant deficiency rises to the level of a material weakness.

The OMB's guidance issued in 2007 also pointed out that the new terminology and definitions may affect the scope of single audits because more internal control related matters are likely to be reported under the new standards. The required reporting of additional internal control matters could affect the determination of major programs and the auditee's low-risk status. The OMB has also revised the data collection form, effective for fiscal years ending in 2008, to reflect the new terminology.

SAS No. 115 Considerations for Single Audits. SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*, supersedes SAS No. 112 (AU 325A) effective for GAAS audits of financial statements for periods ending on or after December 15, 2009, with earlier implementation permitted. Although SAS No. 115 generally carries forward the SAS No. 112 communication requirements and principal guidance on evaluating the severity of deficiencies in internal control, it changes the definitions related to control deficiencies.

SAS No. 115 (AU 325) provides the following definitions of control deficiencies applicable in a GAAS audit:

- *Significant Deficiency.* A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
- *Material Weakness.* A deficiency or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

The substance of the material weakness definitions in SAS No. 112 (AU 325A) and SAS No. 115 (AU 325) are substantially the same, however significant deficiencies are defined more broadly in the new standard. Thus, some believe SAS No. 115 allows more judgment in determining whether control deficiencies are "significant" and, thus, whether they are required to be communicated to management and those charged with governance. The guidance for evaluating the severity of deficiencies in internal control is essentially the same as in SAS No. 112.

In order to address the new GAAS requirements that will be effective when SAS No. 115 (AU 325) is implemented, in November 2008 the GAO issued interim guidance on implementing SAS No. 115 in a Yellow Book audit. The GAO guidance is discussed at paragraph . Because the definitions in SAS No. 115 are easier to understand and apply, some audit firms may consider early adoption. However, although auditors can early implement SAS No. 115 (AU 325) on financial statement audits performed under *Government Auditing Standards*, the GAS/A-133 AICPA Audit Risk Alert, *Government Auditing Standards and Circular A-133 Developments—2008*, Paragraph .80, cautions auditors that OMB Circular A-133 and other similar federal regulations or audit guides have not been updated to reflect new internal control definitions for reporting on internal control over compliance. The risk alert states that it would *not* be appropriate to use SAS No. 115 definitions for reporting on internal control over compliance until OMB Circular A-133 or other regulations or guides are amended to allow usage of new updated definitions. When this course went to press, such amendments had not yet been made and the AICPA had not yet developed illustrative reports that reflect the new internal control definitions in SAS No. 115. Auditors should monitor the AICPA's Governmental Audit Quality Center website at <http://gaqc.aicpa.org/> for release of report examples that use the SAS No. 115 internal control definitions.

Reporting on Compliance with Major Program Requirements

OMB Circular A-133 requires auditors to test major program compliance with laws, regulations, and the provision of contracts or grant agreements that may have a direct and material effect on its major programs. The testing should be adequate to support an opinion on such compliance. Section 505(c) of OMB Circular A-133 requires the auditor's reporting on major program compliance to include the following:

- a. 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.
- b. Where applicable, a reference to the separate schedule of findings and questioned costs.

Material Effect. When reporting on major program compliance, the objective is to express an opinion on whether the governmental unit or nonprofit organization has complied, in all material respects, with the requirements of laws, regulations, contracts, and grants, noncompliance with which *may* have a direct and material effect on each major program. The phrase "direct and material effect" generally means that noncompliance *could* result in being denied reimbursement of program expenditures or having to refund federal monies or make other restitution in an amount that would be material to a major federal program. It can be difficult to assess the materiality of instances of noncompliance because the auditor is not in a position to understand completely some of the implications of instances of noncompliance that might cause federal officials to eliminate or discontinue grants, disallow charges, or demand refunds. However, OMB Circular A-133 does not require an opinion that noncompliance *will* have a direct and material effect, but only that noncompliance *may* have a direct and material effect. It will help the auditor to keep in mind that federal agencies have determined that noncompliance with the compliance requirements listed in the Compliance Supplement may indeed have a direct and material effect.

Auditors should consider both quantitative and qualitative factors when determining whether a noncompliance item has a material effect. Paragraph 10.07 of the GAS/A-133 AICPA Audit Guide indicates that materiality is affected by—

- a. The nature of the compliance requirements (which may be monetary or nonmonetary).
- b. The nature and frequency of noncompliance identified (with consideration given to sampling risk).
- c. Qualitative considerations, such as the needs and expectations of federal awarding agencies and pass-through entities. The GAS/A-133 AICPA Audit Guide indicates at paragraph 10.07 that “qualitative factors that indicate that an identified instance of noncompliance may be immaterial include (1) a low risk of public or political sensitivity, (2) a single exception that has a low risk of being pervasive, or (3) 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.”

Paragraph 10.09 of the GAS/A-133 AICPA Audit Guide further states that reaching a conclusion about whether the effect of noncompliance is 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.” The Yellow Book, at Paragraph 4.26, also mentions that in audits of government programs, the materiality level may be lower than in similar type audits in the private sector because of public accountability of the audited entity, various legal and regulatory requirements, and the visibility and sensitivity of government activities.

SAS No. 74 (AU 801.17) lists the following factors the auditor should consider in evaluating the effect of identified instances of noncompliance on the program:

- a. The frequency of noncompliance identified in the audit.
- b. Whether any instances of noncompliance identified result in questioned costs.
- c. If they do, whether the questioned costs are material to the program.
- d. The adequacy of a primary recipient’s system for monitoring subrecipients and the possible effect on the program of any noncompliance identified by the primary recipient or the subrecipients’ auditors.

Paragraph 10.53 of the GAS/A-133 AICPA Audit Guide states that, in evaluating the effect of questioned costs for purposes of forming an 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).” This guidance is also included in SAS No. 74 (AU 801.18) and in Section 510(a)(3) of OMB Circular A-133. AU 801.18 further states that when sampling is used in testing compliance, “the auditor should project the amount of known questioned costs identified in the sample to the items in the major . . . program from which the sample was selected.” There are no specific guidelines on assessing materiality with respect to a major program. However, many auditors believe that 5% of major program expenditures is a reasonable rule of thumb.

It is suggested that the following criteria may be helpful when deciding whether a finding is material:

- Monetary value of the questioned cost.
- The cumulative effect and impact of smaller items. (A large number of small noncompliance items of a small questioned cost that is not likely to be an isolated incident is more likely to be a material finding.)
- Experience with the activity or changes in its conditions. (A noncompliance finding related to a new program or changes in procedures for an existing program is more likely to be a material finding.)
- Adequacy of internal controls for ensuring compliance in the future. (A noncompliance that relates to, and perhaps was caused by, inadequate internal controls is more likely to be a material finding.)
- Results of prior audits. (Repeat findings are more likely to be material findings.)

- Level and extent of review or other forms of independent oversight. (The greater the degree of independent oversight, the less likely the noncompliance item is a material finding.)

Reporting on Internal Control Over Major Program Compliance

In addition to the matters covered in reporting on internal control over financial reporting required by *Government Auditing Standards*, OMB Circular A-133 requires additional reporting on internal control. The additional matters relate to controls relevant to federal *programs*. Paragraph 9.06 of the GAS/A-133 AICPA Audit Guide uses the term *internal control over compliance* to describe the controls that relate to an audit of compliance with requirements applicable to major programs. Section 500(c) of OMB Circular A-133 and Paragraph 9.03 of the GAS/A-133 AICPA Audit Guide indicate the auditor should 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, and perform tests as planned. Section 505(b) of OMB Circular A-133 requires the auditor's reporting on major program compliance to include the following:

- a. The scope of testing of internal control.
- b. The results of the tests, and, where applicable, a reference to the separate schedule of findings and questioned costs.

Illustrated Auditor's Reports

Reporting When Material Noncompliance Is Identified. When material instances of noncompliance with compliance requirements governing major programs are found, the auditor should qualify the compliance opinion or express an adverse opinion.

Reporting When Audit of Federal Awards Does Not Include All of the Auditee's Operations That Expend Federal Awards

As discussed in Paragraph 12.30 of the GAS/A-133 AICPA Audit Guide, the audit of the federal awards may not cover all of the auditee's operations that expend federal awards. In these instances, the operations not included in the audit should be identified in a separate paragraph following the first paragraph. An example of such a paragraph follows:

[Name of Governmental Unit or Nonprofit Organization] 's financial statements include the operations of the [Identify Component Unit or Department], which received [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 Unit or Department] because [State the reason for the omission, such as the component unit engaged other auditors to perform and audit in accordance with OMB Circular A-133.] .

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

28. Which of the following is not a factor listed in SAS No. 74 that an auditor should consider when evaluating the effect of identified instances of program noncompliance?
- a. If any instances of noncompliance identified result in questioned costs.
 - b. The nature and frequency of noncompliance identified.
 - c. The frequency of noncompliance identified in the audit.
 - d. The adequacy of a primary recipient's system for monitoring subrecipients and the possible effect on the program of any noncompliance identified by the primary recipient or the subrecipients' auditors.
29. Which of the following statements regarding how to determine if a finding is material is true?
- a. Most often a small number of small noncompliance items of a small questioned cost that is likely to be an isolated incident are more likely to be a material finding.
 - b. A noncompliance finding related to a new program or changes in procedures for an existing program is more likely to be a material finding.
 - c. A noncompliance that relates to, and perhaps was caused by, inadequate internal controls is less likely to be a material finding.
 - d. The greater the degree of independent oversight, the more likely the noncompliance item is a material finding.
30. Charlotte has identified material instances of noncompliance with compliance requirements governing major programs in her audit of Rolling Hills Nursing Home. What is Charlotte's next move?
- a. Seek the guidance of an attorney concerning legal responsibilities.
 - b. Disclaim an opinion.
 - c. Use professional judgment.
 - d. Qualify the compliance opinion.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

28. Which of the following is **not** a factor listed in SAS No. 74 that an auditor should consider when evaluating the effect of identified instances of program noncompliance? **(Page 358)**
- a. If any instances of noncompliance identified result in questioned costs. [This answer is incorrect. This is one factor listed in SAS No. 74 that an auditor should consider when evaluating the effect of identified instances of program noncompliance.]
 - b. The nature and frequency of noncompliance identified. [This answer is correct. According to Paragraph 10.07 of the GAS/A-133 AICPA Audit Guide, materiality is affected by the nature and frequency of noncompliance identified.]**
 - c. The frequency of noncompliance identified in the audit. [This answer is incorrect. This is one factor listed in SAS No. 74 that an auditor should consider when evaluating the effect of identified instances of program noncompliance.]
 - d. The adequacy of a primary recipient's system for monitoring subrecipients and the possible effect on the program of any noncompliance identified by the primary recipient or the subrecipients' auditors. [This answer is incorrect. This is also a factor listed in SAS No. 74 that an auditor should consider when evaluating the effect of identified instances of program noncompliance.]
29. Which of the following statements regarding how to determine if a finding is material is true? **(Page 358)**
- a. Most often a small number of small noncompliance items of a small questioned cost that is likely to be an isolated incident are more likely to be a material finding. [This answer is incorrect. Considering the cumulative effect and impact of smaller items may be helpful when deciding if a finding is material. A large number of small noncompliance items of a small questioned cost that is not likely to be an isolated incident are more likely to be a material finding.]
 - b. A noncompliance finding related to a new program or changes in procedures for an existing program is more likely to be a material finding. [This answer is correct. Considering the experience with the activity or changes in its conditions may be helpful when deciding if a finding is material. A noncompliance finding related to a new program or changes in procedures for an existing program is more likely to be a material finding.]**
 - c. A noncompliance that relates to, and perhaps was caused by, inadequate internal controls is less likely to be a material finding. [This answer is incorrect. Considering the adequacy internal controls for ensuring compliance in the future can also be helpful when deciding if a finding is material. A noncompliance that relates to, and perhaps was caused by, inadequate internal controls is more likely to be a material finding.]
 - d. The greater the degree of independent oversight, the more likely the noncompliance item is a material finding. [This answer is incorrect. The greater the degree of independent oversight, the less likely the noncompliance item is a material finding.]
30. Charlotte has identified material instances of noncompliance with compliance requirements governing major programs in her audit of Rolling Hills Nursing Home. What is Charlotte's next move? **(Page 359)**
- a. Seek the guidance of an attorney concerning legal responsibilities. [This answer is incorrect. In the event that officials of Rolling Hills are not willing to make the notifications or to follow sound legal advice regarding the act(s), the Charlotte should seek the guidance of an attorney concerning legal responsibilities.]
 - b. Disclaim an opinion. [This answer is incorrect. According to SAS No. 58, Charlotte should disclaim an opinion when restrictions that significantly limit a scope of the audit are imposed by Rolling Hills.]**

- c. Use professional judgment. [This answer is incorrect. Charlotte should use professional judgment when considering whether and how to communicate internal control deficiencies that have an inconsequential effect on the financial statements. Although professional judgment can be used in addition to other actions, professional judgment alone is not the correct answer.]
- d. **Qualify the compliance opinion. [This answer is correct. When material instances of noncompliance with compliance requirements governing major programs are found, Charlotte should qualify the compliance opinion or express an adverse opinion.]**

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, Section 315(a) of OMB Circular A-133 requires that the auditee prepare a summary schedule of prior audit findings. The auditee is also required to prepare a corrective action plan for current year audit findings.

Since the summary schedule may include audit findings from multiple years, the fiscal year in which the finding initially occurred should also be included, for example 2001-3 or 2002-6. (See Exhibit 1-5.)

Exhibit 1-5

Illustrated Summary Schedule of Prior Audit Findings^{a, b}

ABC Organization Summary Schedule of Prior Audit Findings Year Ended June 30, 20X3

DEPARTMENT OF ENERGY

FINDING 20X2-1:^c Weatherization Assistance for Low-Income Persons.

Condition: This finding was a significant deficiency stating that applications and written authority signed by an authorized official were not required to add individuals to the payroll.

Recommendation: The auditor recommended that procedures be implemented requiring the completion of an application form and the written approval of the personnel director prior to adding applicants to the payroll. Management concurred with the recommendation and indicated that the procedures would be implemented.

Current Status: The recommendation was adopted in August 20X2. No similar findings were noted in the 20X3 audit.^d

FINDING 20X2-2: Weatherization Assistance for Low-Income Persons.

Condition: Documentation of verification of low income status could not be located for three selected grants.

Current Status: The eligibility of the three grants recipients was reverified. No similar findings were noted in the 20X3 audit.^d

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

FINDING 20X1-4: Department of Housing and Urban Development (HUD)—Public Housing Comprehensive Improvement Assistance Program.

Condition: Monies expended on the Stanley Park project were not approved by HUD because appropriate environmental review procedures were not followed.

Recommendation: It was recommended that the responsible city official be reminded of the procedures in place to ensure that such HUD approvals are obtained before funds are obligated and that a waiver of the approval be requested from HUD. The waiver was requested in September 20X0.

Current Status: The finding does not warrant further action. The finding was first reported in the 20X0 schedule of findings and questioned costs in August 20X0. [Author's Note: Assume over two years has passed since the finding was first reported.] HUD has not responded to the waiver request.

FINDING 20X1-5: Head Start Program. The discussion for Finding 20X2-1 also applies to this Finding.

Notes:

- ^a Auditors are reminded that only audit findings relative to federal award programs should be included.
- ^b Circular A-133 requires that the summary schedule "list the audit findings." It is believed listing only the finding number and the current status information meet the minimum requirement, but they believe the additional

information is helpful and suggest its inclusion until further guidance from OMB indicates that it is not necessary.

- c 20X2-1 refers to the year and the finding number; for example 2002-1 or 02-1.
- d There is no specific requirement to indicate that no similar findings were noted in the current audit; however, it is believed the information is helpful and suggest its inclusion until further guidance from OMB indicates that it is not necessary.

* * *

Contents of the Schedule

The summary schedule of prior audit findings is required to report the status of all audit findings included in the prior audit's schedule of findings and questioned costs *relative to federal awards* (not Yellow Book findings). The summary schedule includes audit findings reported in the prior audit's summary schedule of prior audit findings except those listed as fully corrected (see a. below), or no longer valid or not warranting further action (see d. below). (See Paragraphs 10.59 and 10.60 of the GAS/A-133 AICPA Audit Guide.)

- a. When audit findings have been fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.
- b. When audit findings have not been corrected or were only partially corrected, the summary schedule should describe the planned corrective action as well as any partial corrective action taken.
- c. 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 should provide an explanation.
- d. When the auditee believes the audit findings are no longer valid or do not warrant further action, the reasons for this position should 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:
 - (1) Two years have passed since the audit report in which the finding occurred was submitted to the federal clearinghouse;
 - (2) The federal agency or pass-through entity is not currently following up with the auditee on the audit finding; and
 - (3) A management decision was not issued.

Paragraph 12.41 of the GAS/A-133 AICPA Audit Guide indicates that if there are no prior findings to report on, the auditee is not required to prepare a summary schedule. Federal agencies and other interested parties can use the Federal Audit Clearinghouse database to determine that the requirements of OMB Circular A-133 were met.

Illustrated Schedule

An illustrated summary schedule of prior audit findings is provided at Exhibit 1-5. Other formats may be equally acceptable.

REPORTS ON FRAUD, ILLEGAL ACTS, AND OTHER MATTERS

In evaluating and reporting findings, auditors should distinguish between fraud or illegal acts (i.e., violations of laws or regulations), violations of provisions of contracts or grant agreements, and abuse. Auditors should also distinguish between findings that involve federal awards and those that do not.

- a. *Findings Involving Federal Awards.* Findings involving federal awards that are subject to OMB Circular A-133 reporting should be reported in accordance with the requirements of OMB Circular A-133. Auditors

should use professional judgment to determine the appropriate additional reporting of findings that are included in the OMB Circular A-133 report when those findings are also material to the financial statements. Such findings should also be included in the Yellow Book report on internal control over financial reporting and compliance and other matters. Findings that involve federal awards but do not meet the requirements for OMB Circular A-133 reporting should be communicated in a management letter unless they are clearly inconsequential to the financial statements.

- b. *Findings That Do Not Involve Federal Awards or Are Not Subject to OMB Circular A-133 Reporting.* Fraud and illegal acts that do not involve federal awards or OMB Circular A-133 reporting but have an effect on the financial statements that is more than inconsequential should be included in the Yellow Book report on internal control over financial reporting and compliance and other matters. Likewise, violations of contract or grant agreements that have a material effect on the financial statements, and abuse that is material, either quantitatively or qualitatively, should also be reported in the Yellow Book report on internal control. Violations of contract or grant agreements, or abuse, that have a less than material but more than inconsequential effect on the financial statements should be communicated to the entity's officials in writing (e.g., in a management letter.) If such violations or abuse are detected but are inconsequential to the financial statements, auditors should use professional judgment to determine whether and how to report the violations or abuse. Any such communications should be documented.

Government Auditing Standards

Fraud and Illegal Acts. Under *Government Auditing Standards*, the auditor's responsibility for reporting fraud or illegal acts that have occurred or are likely to have occurred extend beyond the AICPA's professional requirements. A discussion of other considerations related to audit findings follows.

Illegal Acts. Footnote 68 to Paragraph 5.15 of the Yellow Book cautions the auditor that whether an act is, in fact, illegal may have to await determination in a court of law or other adjudicative body and that disclosing matters that have led them to conclude that an illegal act is likely to have occurred is not a final determination of illegality.

Consult with an Attorney. This course strongly recommends that the auditor consult with an attorney on whether a reportable act has occurred and on the wording of the report on fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse or possible acts noted, when a report is issued. In this way, the auditor is protected and any prosecutions that might result from the act will not be prejudiced. Because of the complexity and sensitivity of these disclosures, examples are not provided in any of the authoritative literature or in this course.

In the rare event that officials of the audited entity are not willing to make the notifications referred to in this lesson, or to follow sound legal advice regarding the act(s), the auditor should seek the guidance of an attorney concerning legal responsibilities, including possible withdrawal from the engagement. SAS No. 54 and SAS No. 99 discuss situations in which the auditor should consult with his or her attorney regarding withdrawal from the engagement. The auditor should, of course, carefully document all communications related to the matter and its disposition.

Abuse. The Yellow Book includes provisions defining abuse and the auditor's responsibility when information comes to his or her attention indicating that abuse may have occurred.

Abuse Relating to Federal Awards. The Yellow Book fieldwork standard that requires auditors to be alert for situations or transactions that could be indicative of abuse applies to all aspects of a single audit engagement, including the compliance audit portion. However, auditors should not confuse abuse with instances of noncompliance. The Yellow Book, at Paragraph 4.12, states that:

Abuse 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. Abuse does not necessarily involve fraud, violation of laws, regulations, or provisions of a contract or grant agreement.

Paragraphs 8.48 and 12.36 of the GAS/A-133 AICPA Audit Guide explain that, although situations or transactions involving federal awards might appear to constitute abuse, they usually are instances of noncompliance. The

determination of abuse is subjective; therefore auditors are not required to provide reasonable assurance of detecting abuse. If the auditor detects abuse, the Yellow Book requires the auditor to perform procedures designed to ascertain the potential effect on the financial statements or other financial data significant to the audit. However, when abuse that involves federal awards occurs and is material to a major program, the finding should be reported in the federal awards section of the schedule of findings and questioned costs and referred to from the OMB Circular A-133 report. If the abuse is material to the financial statements, the finding should be reported in the financial statement section of the schedule of findings and questioned costs and referred to from the Yellow Book report. If abuse relates to both the financial statements and federal awards, it should be reported in both sections, although one may be summarized.

COMMUNICATING CONTROL DEFICIENCIES AND OTHER COMMENTS

Control Deficiencies

Although *Government Auditing Standards* do not require an auditor to perform procedures specifically to identify deficiencies in internal controls, the auditor must communicate certain control deficiencies when they are identified during the audit. 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—

- a. prevent or detect misstatements on a timely basis, or
- b. prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis.

When control deficiencies are identified, the auditor is required to evaluate them to determine if they are significant deficiencies or material weaknesses. For the Yellow Book internal control report, the auditor considers both the likelihood and magnitude of potential misstatement in the financial statements when evaluating the significance of a control deficiency. Note that the auditor considers the *potential* for misstatement, not whether misstatement has occurred. The absence of identified misstatement does not indicate that control deficiencies are not significant deficiencies or material weaknesses. The Yellow Book and SAS No. 112 (AU 325A) use the terms *more than a remote likelihood* and *more than inconsequential* as thresholds for determining whether the likelihood and magnitude, respectively, of a control deficiency result in a significant deficiency.

Yellow Book and Single Audit Requirements. In addition to the overall standards for reporting internal control deficiencies, the Yellow Book, at Paragraph 5.10, provides a specific reporting threshold for fraud and illegal acts. All instances of fraud and illegal acts, unless *inconsequential*, are required to be reported. For single audits, the auditor should also evaluate internal control matters in relation to major federal award programs. Section 505(d)(1)(ii) and (iv) of OMB Circular A-133 requires that all significant deficiencies and material weaknesses (both those related to the financial statements and those related to the major federal award programs) be reported in the schedule of findings and questioned costs. The Yellow Book also requires auditors to report significant deficiencies and material weaknesses.

A significant deficiency is a material weakness when its effect on the financial data is likely to be material. For the Yellow Book internal control report, materiality is measured against the basic financial statements. For the single audit, materiality is measured in relation to a type of compliance requirement for a major program.

Control deficiencies, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse are all examples of audit findings. When auditors identify findings, they should plan and perform procedures to develop the elements of the audit finding that are relevant and necessary to achieve the audit objectives. Stated another way, the elements that are required for a particular finding depend on the relevant audit objective; all elements are not required for every finding. The 2007 Yellow Book, beginning at Paragraph 4.15, describes these elements as criteria, condition, cause, and effect or potential effect.

Illustrated Comments. There are numerous formats used for reporting significant deficiencies and material weaknesses. The illustrated schedule of findings and questioned costs at Exhibit 1-6 presents one example.

Management Letters

Management letters (or another form of written communication) should be used to communicate matters that are not required to be included in the auditor's reports. For example, the Yellow Book requires that certain audit findings that do not meet the threshold for required inclusion in the reports on internal control be communicated in writing to the auditee. Thus, violations of provisions of contracts or grant agreements or abuse that have a less than material, but more than inconsequential, effect on the financial statements should be communicated in writing to officials of the audited entity. The auditor is not required to report findings that are inconsequential. The Yellow Book, at Paragraph 5.16, states; "Determining whether and how to communicate to officials of the audited entity fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that is inconsequential is a matter of professional judgment." (All instances of fraud and illegal acts should be reported as internal control deficiencies, unless inconsequential.)

It is believed that in most cases, it is preferable to communicate inconsequential matters, as defined by *Government Auditing Standards*, in a management letter. Also, neither GAAS SAS No. 112 nor the Yellow Book precludes communicating other items in a management letter, such as recommendations for improving internal controls or operational efficiencies. If less serious control deficiencies or other inconsequential audit findings are communicated orally, the auditor should document the communication. The GAS/A-133 AICPA Audit Guide, at Paragraph 4.38, recommends that auditors use language in the management letter that enables readers to distinguish between matters that are required to be reported from those that are not required. Auditors should include in their audit documentation evidence of all communications to officials of the audited entity about deficiencies in internal control found during the audit.

Paragraph 5.09 of the Yellow Book states that if the management letter contains items that are required to be communicated to entity officials, the auditor should refer to that management letter in the report on internal control over financial reporting and on compliance and other matters. 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. However, auditors may choose to make reference to that communication in their communication of significant deficiencies. In this case, a sentence such as the following could be added as the next to last paragraph of the communication of significant deficiencies and material weaknesses:

In addition, we noted other matters involving the internal control and its operation that we have reported to management of [Name of Governmental Unit or Name of Nonprofit Organization] in a separate letter dated February 14, 20X2.

OMB Circular A-133 has no specific requirement for auditors to provide a management letter. However, because single audits must be performed in accordance with *Government Auditing Standards*, there is an indirect requirement for auditors to communicate in a management letter information about matters that are not significant enough to be reported as findings, including recommendations for improving operational efficiency, internal controls, or policies and procedures. Auditors are precluded from using management letters to communicate any findings that OMB Circular A-133 requires to be reported in the schedule of findings and questioned costs. Therefore, auditors should not refer to a separate management letter in their OMB Circular A-133 report on compliance and internal controls because all reportable findings would already be included in the schedule of findings and questioned costs.

Authoritative literature contains very little discussion and no required format for, or illustrations of, these letters. As previously indicated, nonreportable conditions may be communicated orally or in written form. It is believed the written form of communication is preferable. Management letters may make a stronger impression on the client because they are more formal than a casual discussion. Management may route applicable portions of the letter to other personnel involved in the areas addressed. Also, a letter gives the auditors a record of points that are made that can be referred to when determining what action the client took and when preparing management points in subsequent years.

Introductory Content of the Management Letter. Although it is believed management points should be written, the letters need not be as formal as the other reports illustrated in this lesson. Management letters should not be

“boilerplates,” because they may deal with such a wide range of topics. Rather, they should be responsive to the individual client situation and the auditors’ actual observations. Management points might be communicated by any combination of descriptive commentary, tabular arrangements, graphs, lists, and illustrations. However, this course recommends that all management letters include certain introductory information designed to prevent client misunderstanding about the nature of the comments or that the letter represents assurance about the adequacy of controls.

Suggested relevant aspects of a management letter include the following:

- a. The letter should be dated the same date as the auditor’s report on the financial statements. However, the auditor may also choose to communicate significant matters during the course of the audit when timely communication is important.
- b. Management letters should be addressed to those charged with governance and senior management.
- c. A statement that the letter is a result of the audit of the financial statements.
- d. A statement that during the audit certain immaterial matters were noted and that these matters are summarized in this letter. Some auditors prefer to include the comments in a separate memorandum.
- e. A reference is made to any separate report on internal control or separate communication of internal control deficiencies.
- f. The letter may be used for the required written communication of violations of contract or grant agreements, or abuse, that have a less than material but more than inconsequential effect on the financial statements in an audit performed according to *Government Auditing Standards*.
- g. Some auditors include a statement that the management points will be reviewed the following year. Such a statement can make an impression about their seriousness to the auditors and may prompt the client to take their implementation more seriously.
- h. Auditors may offer to discuss the points with management, to perform any necessary follow-up studies, or to assist in implementing the recommendations.
- i. Auditors should draft the letter with the understanding that a copy of the letter may be submitted to government agencies. Since the information may also be available to the press and general public under the Freedom of Information Act, the letter should not include names, social security numbers, other personal identification, or other potentially sensitive matters.
- j. Due to materiality and other considerations, comments may be significant deficiencies to one entity and not another.

Due to the public availability of financial documents of many entities, auditors should not include information of a personal or sensitive nature (such as names or social security numbers) in a management letter.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. When should the summary schedule provide an explanation?
- a. When audit findings have been fully corrected.
 - b. When audit findings have not been corrected or were only partially corrected.
 - c. When corrective action taken is significantly different from corrective action previously reported in a corrective action plan.
 - d. When the auditee believes the audit findings are no longer valid.
32. Which of the following should be included in the Yellow Book report on internal control?
- a. Contract violations, not involving federal awards, which have more than an inconsequential effect on financial statements.
 - b. Contract violations, not involving federal awards, that have a material affect on the financial statements.
 - c. Findings that involve federal awards but do not meet the requirements for OMB Circular A-133.
33. Which of the following statements regarding abuse relating to federal awards is most accurate?
- a. Most instances of noncompliance include some type of abuse.
 - b. The determination of abuse is subjective.
 - c. If abuse that involves federal awards occurs and is material to a major program, the finding should be reported in the federal awards section of the schedule of findings and questioned costs and referred to from the Yellow Book report.
 - d. OMB Circular A-133 requires an auditor to perform procedures designed to ascertain the potential effect on the financial statements.
34. This course suggests a few relevant aspects of a management letter. Which of the following is **not** recommended?
- a. The letter should be dated the same as the date as the auditor's report on the financial statements.
 - b. Summarization that during the audit certain immaterial matters were noted.
 - c. Findings that OMB Circular A-133 requires to be reported in the schedule of findings.
 - d. Matter to be reviewed the following year.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

31. When should the summary schedule provide an explanation? **(Page 365)**

- a. When audit findings have been fully corrected. [This answer is incorrect. The summary schedule need only list the audit findings and state that corrective action was taken when audit findings have been fully corrected.]
- b. When audit findings have not been corrected or were only partially corrected. [This answer is incorrect. The summary schedule should describe the planned corrective action as well as any partial corrective action taken when audit findings have not been corrected or were only partially corrected.]
- c. **When corrective action taken is significantly different from corrective action previously reported in a corrective action plan. [This answer is correct. The summary schedule should provide an explanation 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.]**
- d. When the auditee believes the audit findings are no longer valid. [This answer is incorrect. When the auditee believes the audit findings are no longer valid or does not warrant further action, the reasons for this position should be described in the summary schedule.]

32. Which of the following should be included in the Yellow Book report on internal control? **(Page 365)**

- a. Contract violations, not involving federal awards, which have more than an inconsequential effect on financial statements. [This answer is incorrect. Violations of contract or grant agreements, or abuse, which have a less than material but more than inconsequential effect on the financial statements, should be communicated to the entity's officials in writing.]
- b. **Contract violations, not involving federal awards, that have a material affect on the financial statements. [This answer is correct. Violations of contract or grant agreements that have a material effect on the financial statements, and abuse that is material, either quantitatively or qualitatively, should also be reported in the Yellow Book report on internal control.]**
- c. Findings that involve federal awards but do not meet the requirements for OMB Circular A-133. [This answer is incorrect. Findings that involve federal awards but do not meet the requirements for OMB Circular A-133 reporting should be communicated in a management letter unless they are clearly inconsequential to the financial statements.]

33. Which of the following statements regarding abuse relating to federal awards is most accurate? **(Page 366)**

- a. Most instances of noncompliance include some type of abuse. [This answer is incorrect. Paragraphs 8.48 and 12.36 of the GAS/A-133 AICPA Audit Guide explain that, although situations or transactions involving federal awards might appear to constitute abuse, they usually are instances of noncompliance.]
- b. **The determination of abuse is subjective. [This answer is correct. The determination of abuse is subjective; therefore auditors are not required to provide reasonable assurance of detecting abuse.]**
- c. If abuse that involves federal awards occurs and is material to a major program, the finding should be reported in the federal awards section of the schedule of findings and questioned costs and referred to from the Yellow Book report. [This answer is incorrect. When abuse involving federal awards occurs, and is material to a major program, the finding should be reported in the federal awards section of the schedule of findings and questioned costs and referred to from the OMB Circular A-133 report.]

- d. OMB Circular A-133 requires an auditor to perform procedures designed to ascertain the potential effect on the financial statements. [This answer is incorrect. If the auditor detects abuse, the Yellow Book requires the auditor to perform procedures designed to ascertain the potential effect on the financial statements or other financial data significant to the audit.]
34. This course suggests a few relevant aspects of a management letter. Which of the following is **not** recommended? **(Page 368)**
- a. The letter should be dated the same as the date as the auditor's report on the financial statements. [This answer is incorrect. The letter should be dated the same date as the auditor's report on the financial statements. However, the auditor may also choose to communicate significant matters during the course of the audit when timely communication is important.]
 - b. Summarization that during the audit certain immaterial matters were noted. [This answer is incorrect. A statement indicates that during the audit certain immaterial matters were noted, and that these matters are summarized in this letter. Some auditors prefer to include the comments in a separate memorandum.]
 - c. **Findings that OMB Circular A-133 requires to be reported in the schedule of findings. [This answer is correct. Auditors are precluded from using management letters to communicate any findings that OMB Circular A-133 requires to be reported in the schedule of findings and questioned costs.]**
 - d. Matter to be reviewed the following year. [This answer is incorrect. Some auditors include a statement that the management points will be reviewed the following year. Such a statement can make an impression about their seriousness to the auditors and may prompt the client to take their implementation more seriously.]

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Section 510 of OMB Circular A-133 requires the auditor to report all findings meeting specified criteria in a schedule of findings and questioned costs. Findings include significant deficiencies, material instances of noncompliance, known questioned costs exceeding \$10,000, and certain other findings. A summary of the audit results must also be included. As a result of the requirement to include this summary, a schedule of findings and questioned costs is required for all such audits even if "findings" and "questioned costs" are not identified. There is no requirement to report other findings such as immaterial findings or internal control matters (i.e., management letter comments) that are not considered to be significant deficiencies.

In addition to material instances of noncompliance and abuse, the Yellow Book also requires disclosure of relevant information when, based on the evidence obtained, fraud or an illegal act, that is not inconsequential, either has occurred or is likely to have occurred. Immaterial compliance findings and fraud or illegal acts that are inconsequential need not be included in the report.

What Is Included in the Schedule of Findings and Questioned Costs?

Section 505(d) of OMB Circular A-133 requires inclusion of a schedule of findings and questioned costs in the reporting package and states that the schedule should include the following:

- a. A summary of the auditor's results including:
 - (1) The type of report the auditor issued on the financial statements (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - (2) Where applicable, a statement that significant deficiencies in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses, as required to be reported in accordance with *Government Auditing Standards*.
 - (3) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee, as required to be reported in accordance with *Government Auditing Standards*.
 - (4) Where applicable, a statement that significant deficiencies in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.
 - (5) The type of report the auditor issued on compliance for each major program (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - (6) A statement as to whether the audit disclosed any audit findings that the auditor is required to report.
 - (7) An identification of major programs. (The illustrative schedule of findings and questioned costs included on the AICPA's website indicates in footnote 4 that 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 only required to list the name of the cluster and not each individual program within the cluster.)
 - (8) The dollar threshold used to distinguish between Type A and Type B programs.
 - (9) A statement as to whether the auditee qualified as a low-risk auditee.
- b. Findings relating to item a(2) and (3) (if any) relative to the financial statements.
- c. Findings and questioned costs referred to in item a(4), (5), and (6) (if any) relative to the major federal award programs, including, if applicable, findings of abuse. This section should:
 - (1) Present audit findings (e.g., internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue as one finding. Findings should be organized by federal agency or pass-through entity, if practical to do so.

- (2) Report audit findings that relate to both the financial statements and federal awards in both sections of the schedule. (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.)

Findings Relating to the Financial Statements. As noted at paragraph and b., Section 505(d)(2) of OMB Circular A-133 requires the schedule of findings and questioned costs to include a section that reports findings relating to the financial statements. As indicated at Paragraph 12.33 of the GAS/A-133 AICPA Audit Guide, these findings must be addressed in the Yellow Book report on internal control over financial reporting and on compliance and other matters. The financial statement section on the schedule of findings and questioned costs should include the following:

- Significant deficiencies, (including significant deficiencies that are material weaknesses) 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. Reporting findings of abuse is also discussed in Paragraph 12.36 of the GAS/A-133 AICPA Audit Guide.)

Findings Relating to Both the Financial Statements and Federal Awards. Audit findings that relate to both the financial statements and federal awards should be reported as findings relative to both the financial statements in item b. and the major programs in item c. However, the reporting in one part of the schedule may be in summary form with a reference to a detailed reporting in the other part of the schedule.

Findings

Section 510(a) of OMB Circular A-133 indicates that the following should be reported as findings in the federal awards section of the schedule of findings and questioned costs.

- a. *Significant Deficiencies in 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 an audit objective identified in the Compliance Supplement. The auditor should identify significant deficiencies which are individually or cumulatively material weaknesses.
- 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 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.
- c. *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 should also report *known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program.* (However, the likely questioned costs should not be reported.) In reporting questioned costs, the auditor should include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

There is no prohibition against reporting findings of less than \$10,000. However, it should be noted that all findings reported must be covered in the corrective action plan as well as the following year's summary

schedule of prior audit findings. This course generally recommends that findings that do not meet the reporting criteria not be reported in the schedule. These findings could be reported to management orally or in a management letter.

- d. *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 normally will 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 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.
- 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.* OMB Circular A-133 does not require the auditor to make an additional report when the auditor confirms that the fraud was reported outside of his reports under the direct reporting requirements of GAGAS.
- g. *Instances Where the Results of Audit Follow-up Procedures Disclosed That the Summary Schedule of Prior Audit Findings Prepared by the Auditee Materially Misrepresents the Status of Any Prior Audit Finding.*

Exhibit 1-6

Illustrated Schedule of Findings and Questioned Costs

ABC Organization Schedule of Findings and Questioned Costs Year Ended June 30, 20X2

SUMMARY OF AUDITOR'S RESULTS

1. The auditor's report expresses an unqualified opinion on the financial statements of [Name of Organization].
2. Two significant deficiencies disclosed during the audit of the financial statements are reported in the [Name of Report]. One of the deficiencies is reported as a material weakness.
3. No instances of noncompliance material to the financial statements of [Name of Organization], which would be required to be reported in accordance with *Government Auditing Standards*, were disclosed during the audit.
4. One significant deficiency in internal control over major federal award programs disclosed during the audit is reported in the [Name of Report]. The deficiency is not reported as a material weakness.
5. The auditor's report on compliance for the major federal award programs for [Name of Organization] expresses an unqualified opinion on all major federal programs.
6. Audit findings that are required to be reported in accordance with Section 510(a) of OMB Circular A-133 are reported in this Schedule.
7. The programs tested as major programs included: [Names and CFDA Nos.].
8. The threshold used for distinguishing between Type A and B programs was [Amount].
9. [Name of Organization] qualified as a low-risk auditee.

FINDINGS—FINANCIAL STATEMENT AUDIT ^a

SIGNIFICANT DEFICIENCIES

20X2-1^b Payroll

Condition: Applications and written authority signed by an authorized official are not required to add individuals to the payroll.

Criteria: Internal controls should be in place that provide reasonable assurance that individuals are added to the payroll only after proper management approval.

Cause: There are no procedures in place to require management’s written authorization to add individuals to the payroll.

Effect: Because of the failure to require approval from the proper level of management, employees may be added to the payroll without the approval or knowledge of management.

Recommendation: Procedures should be implemented requiring the completion of an application form and the written approval of a senior officer prior to adding applicants to the payroll.

Response: ABC Organization agrees with the finding and the recommended procedures have been implemented.

20X2-2 Not Illustrated.

FINDINGS AND QUESTIONED COSTS—MAJOR FEDERAL AWARD PROGRAMS AUDIT ^{a, c}

	Questioned Costs
DEPARTMENT OF ENERGY	
20X2-3 Weatherization Assistance for Low-Income Persons—CFDA No. XX.XXX; Grant No. XXXXX; Grant period—Year ended December 31, 20X1	
<i>Significant Deficiency:</i> ^d As discussed at Finding 20X2-1, applications and written authority signed by an authorized official are not required to add individuals to the payroll, including the payroll charged to federal awards. Because of the failure to require approval from the proper level of management, employees may be added to the payroll and charged to federal awards without the approval or knowledge of management. Procedures should be implemented requiring the completion of an application form and the written approval of a senior officer prior to adding applicants to the payroll.	
20X2-4 Weatherization Assistance for Low-Income Persons—CFDA No. XX.XXX; Grant No. XXXXX; Grant period—Year ended December 31, 20X1	
<i>Statement of Condition:</i> Documentation of verification of low income status could not be located for three selected grants.	
<i>Criteria:</i> Eligibility for the program requires family income below the poverty level.	
<i>Effect:</i> The cost of the assistance may be disallowed.	
<i>Population and Sample Size:</i> A sample of 46 grants totaling \$118,000 was selected for audit from a population of 200 grants totaling \$500,000. Three grants with questioned costs totaling \$8,000 were found in noncompliance.	
	\$ 8,000 ^e

Questioned Costs

Cause of Condition: Procedures are in place for supervisory approval of documentation before assistance is authorized but documentation was apparently not filed correctly.

Recommendation: ABC Organization should again verify the eligibility of the recipients whose documentation could not be located.

Response: ABC Organization agrees with the finding and is in the process of re-verifying the eligibility of recipients whose documentation could not be located.

Total—Department of Energy	\$ <u>8,000</u>
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DEPARTMENT OF HEALTH AND HUMAN SERVICES

20X2-5 Head Start Program—CFDA No. XX.XXX; Grant No.—XXXXX; Grant period—year ended June 30, 20X2

Significant Deficiency: The significant deficiency at Finding 20X2-1 and 20X2-3 also applies to this grant.^d

Total—Department of Health and Human Services	<u>—</u>
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Total	\$ <u><u>8,000</u></u>
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Notes:

- ^a The findings included in this illustrated schedule are for illustrative purposes only. Inclusion here is not intended to suggest these conditions should always be considered findings.
- ^b 20X2-1 refers to the year and the finding number; for example 2002-1 or 02-1.
- ^c These findings are based on actual findings. The continued applicability of the compliance requirements has not been verified.
- ^d Section 505(d)(3)(ii) of OMB Circular A-133 indicates that findings which relate to both the financial statements and federal awards must be reported in both sections of the Schedule. However, the reporting in one section may be in summary form with reference to a detailed reporting in the other section.
- ^e The auditor should report known questioned costs when likely questioned costs exceed \$10,000. In this example, the likely questioned cost could have been calculated as \$33,898 ($\$500,000 \div \$118,000 \times \$8,000$).

* * *

Exhibit 1-7**Illustrated Schedule of Findings and Questioned Costs**

XYZ Organization
Schedule of Findings and Questioned Costs
Year Ended June 30, 20X2

SUMMARY OF AUDITOR'S RESULTS

1. The auditor's report expresses a qualified opinion on the financial statements of [Name of Organization].^a
2. No significant deficiencies relating to the audit of the financial statements are reported in the [Name of Report].^b
3. No instances of noncompliance material to the financial statements of [Name of Organization] were disclosed during the audit.
4. No significant deficiencies relating to the audit of the major federal award programs are reported in the [Name of Report].^b
5. The auditor's report on compliance for [Name of Major Federal Award Program] expresses a qualified opinion; the report on the remaining program is unqualified.^c
6. Audit findings that are required to be reported in accordance with Section 510(a) of OMB Circular A-133 are reported in this Schedule.
7. The programs tested as major programs include: [Names and CFDA Nos.].
8. The threshold used for distinguishing between Type A and B programs was [Amount].
9. [Name of Organization] did not qualify as a low-risk auditee.

FINDINGS—FINANCIAL STATEMENTS AUDIT

None

FINDINGS AND QUESTIONED COSTS—MAJOR FEDERAL AWARD PROGRAMS AUDIT^{d, e}

**Questioned
Costs**

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Public Housing Comprehensive Improvement Assistance Program—CFDA No. XX.XXX

20X2-1^f Grant No. B-78-MC 14-00009—Year ended April 30, 20X2

Condition and Criteria: A vehicle equipped with special photographic equipment was purchased and used in sewer inspections. The Department of Housing and Urban Development (HUD) approval was not obtained prior to its acquisition.

Effect: The purchase price is subject to disallowance and is, therefore, considered a questioned cost.

Cause: Procedures in place to ensure that HUD approval was obtained, where required, were not followed.

Population and Items Tested: A sample of 25 grants totaling \$480,000 was selected for audit from a population of 120 grants totaling \$2,760,000. One grant with questioned costs totaling \$28,765 were found in noncompliance.

\$ 28,765

**Questioned
Costs**

Auditor's Recommendation: The responsible city official should be reminded of the procedures in place to ensure that HUD approval is obtained.

Grantee Response: The city agrees with the finding. A request has been made for a waiver on the approval. The official responsible for obtaining the approval is no longer with the city. The person now with that responsibility has been reminded of the procedures.⁹

20X2-2 Grant No. B-80-MC-4-0009—Year ended April 30, 20X2

Condition: Monies expended on the Stanley Park project were not approved by HUD.

Criteria: HUD did not approve the project because appropriate environmental review procedures were not followed.

Effect: The costs are subject to disallowance and refund to HUD.

Cause: Procedures in place requiring HUD approval were not followed.

Population and Items Tested: A sample of 36 grants totaling \$960,000 was selected for audit from a population of 175 grants totaling \$4,277,500. Two grants with questioned costs totaling \$49,843 were found in noncompliance.

49,843

Auditor's Recommendation: The responsible city official should be reminded of the procedures in place to ensure that HUD approval is obtained.

Grantee Response: The city intends to repay HUD for these costs.⁹

Total—Public Housing Comprehensive Improvement Assistance Program

78,608

Total—Department of Housing and Urban Development

\$ 78,608

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Work Incentive Program—CFDA No. XX.XXX

20X2-3 Grant No. 18-9-0468-47—Year ended June 30, 20X2

Condition and Criteria: Wages were paid to two participants at an hourly rate in excess of that allowable by the program.

Effect: The excess wages are questioned costs.

Cause: This occurred because no procedure was in place in the personnel department to ensure that wage rates were in compliance with program requirements.

Population and Items Tested: A sample of 30 grants totaling \$250,000 was selected for audit from a population of 150 grants totaling \$1,250,000. Two grants with questioned costs totaling \$1,232 were found in noncompliance

\$ 1,232

Auditor's Recommendation: At present there is no final approval by management of the payroll. Procedures should be established requiring approval by grant management of each payroll. The approval should indicate that the wage rates are in compliance with grant agreements.

Grantee Response: The recommended procedures have been established.⁹

**Questioned
Costs****20X2-4 Grant No. 06-9029-xx—Year ended March 31, 20X2**

Conditions and Criteria: The city has no general indirect cost allocation plan approved under the provisions of OMB Circular A-87. However, the city had previously entered into a specific agreement with the Department of Health and Human Services (HHS) which provided that certain personnel costs incurred in support of work incentive programs in departments other than the city's Department of Human Resources could be charged to the grant, provided such charges were based on actual time spent in support of the program. This agreement, which was dated December 31, 20X0, expired on December 31, 20X1. In the year under audit, the city charged a total of \$203,486 to grant 06-9029-XX under the terms of the agreement. Of the \$203,486, \$36,658 was incurred prior to January 1, 20X2. The remaining \$166,828 was incurred subsequent to January 1, 20X2, after the agreement had expired.

Effect: The \$166,828 was incurred after the contract expired and is subject to being disallowed.

166,828

Cause: This occurred because no procedure was in place to ensure that the contract was extended.

Auditor's Recommendation: An extension of the agreement should be requested. If not obtained, the \$166,828 should not be charged against the grant.

Grantee Response: An extension of the agreement has been requested. If not received, the \$166,828 will be returned to HUD.⁹

Total—Work Incentive Program

168,060

Total—Department of Health and Human Services

\$ 168,060

DEPARTMENT OF TRANSPORTATION**20X2-5 Urban Mass Transit Administration—CFDA No. XX.XXX, Grant No. 872-8190-41, Year ended June 30, 20X2**

Conditions and Criteria: This program allows contributions to a self-insurance escrow account as eligible expenses subject to certain conditions. One of these conditions is that the amounts represented as eligible expenses must reflect actual cash deposits to the account. During 20X2, expenses claimed totaled \$4,255,612 while cash deposited totaled only \$3,730,255.

Effect: The difference of \$525,387 is subject to being disallowed.

\$ 525,387

Cause: Procedures to ensure the city that the full amount that can be claimed in being contributed are not in place.

Auditor's Recommendation: Procedures should be established to ensure that the city contributes the required amount to the escrow account to allow the maximum amount as an eligible expense. Such a procedure might be to include on the monthly financial statement a step requiring approval of management before these amounts can be charged to a grant. Management should also be reminded of the requirement to make the required cash deposits. If the required amount is not contributed, the amount not contributed should not be charged as an expense of the grant.

**Questioned
Costs**

Grantee's Response: The City agrees with the finding and the auditor's recommendations have been adopted.⁹

Total—Department of Transportation	\$ 525,387
Total	<u>\$ 772,055</u>

Notes:

- ^a Section 505(d)(1)(i) in OMB Circular A-133 does not require a description of the report qualification.
- ^b It is believed, based on Section 505(d)(1)(ii) and (iv) in OMB Circular A-133, that it is not necessary to state that no significant deficiencies were disclosed. However, they also believe that auditors who wish may do so.
- ^c Section 505(d)(1)(v) in OMB Circular A-133 does not require a description of the qualification.
- ^d The findings included in this illustrated schedule are for illustrative purposes only. Inclusion here is not intended to suggest these conditions should always be considered findings.
- ^e These findings are based on actual findings. This course has not verified the continued applicability of the compliance requirements.
- ^f 20X2-1 refers to the year and the finding number; for example, 2002-1 or 02-1.
- ^g A response is only required "to the extent practical" and "when there is a disagreement with the audit findings." However, there is no prohibition on a response and in some instances the inclusion can be informative.

* * *

Findings That Cannot Be Quantified. While many of the criteria for reporting findings noted above relate to monetary thresholds, auditors may also encounter instances of noncompliance that cannot be quantified. This situation is illustrated in Paragraph 8.60 of the GAS/A-133 AICPA Audit Guide by the following example. Assume that a pass-through entity consistently fails to provide its subrecipients with information about federal awards. Paragraph 8.60 notes that OMB Circular A-133 requires that auditor to consider all findings in relation to a type of compliance requirement (in this case, subrecipient monitoring) or an audit objective identified in the Compliance Supplement (in this case, "determine whether the pass-through entity identifies federal award information and compliance requirements to the subrecipient"). In this situation, the pass-through entity's failure to provide information on federal awards to subrecipients would be a material noncompliance in relation to the audit objective and should be reported as a finding. The auditor should also consider whether significant deficiencies exist, and related reporting requirements, with respect to subrecipient monitoring.

Findings that do not involve federal funds (such as violations of state or local laws) generally should not be included in the schedule of findings and questioned costs. Those findings should be reported on a separate schedule or if included in the schedule, they should be segregated from findings related to federal programs. (Some states have adopted their own single audit type requirements and may have other reporting requirements that should be complied with.)

Questioned Costs

Questioned costs are costs the auditor believes may not comply with or be consistent with the requirements set forth in contracts, laws, statutes, or regulations governing the allocability, allowability, or reasonableness of costs

charged to federal programs and, thus, may not be reimbursable. The Inspector General Act Amendments of 1988 defines questioned cost as—

- a. An alleged violation of a provision of law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds.
- b. A finding that, at the time of the audit, such cost is not supported by adequate documentation.
- c. A finding that the expenditure of funds for the intended purpose is unnecessary or unreasonable.

Section 105 of OMB Circular A-133 defines questioned cost as a cost that is questioned by the auditor because of an audit finding—

- a. Which resulted from a 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. Where the costs, at the time of the audit, are not supported by adequate documentation.
- c. Where the costs incurred appear unreasonable and do not reflect the actions of a prudent person in these circumstances.

There is no requirement for the auditor to expand the scope of the audit to determine with any greater precision the amount of questioned costs to report in the schedule of findings and questioned costs. There are situations, however, where the finding may be a basis for reporting the entire cost of a program as a questioned cost. For example, if the eligibility requirements the audited entity must meet to participate in the program are not met, or if matching or cost-sharing requirements are not met, the grantor may disallow all of the expenditures and request a refund of all program funds. In these cases, the entire program should be reported as questioned costs.

Reporting Noncompliance

General guidance for preparing the schedule of findings and questioned costs is found in the Yellow Book at Paragraphs 4.14–.18; OMB Circular A-133 at Section 510(b); the GAS/A-133 AICPA Audit Guide at Paragraphs 12.35 and 12.37–.38; and PCIE Position Statement No. 6, question no. 44. These documents are included in *PPC's Government Documents Library*. A summary of this guidance follows:

- a. The schedule should include a summary of all findings as defined in the above paragraph on “Findings.” The 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.
- b. The findings should be organized by federal programs so the reader can readily relate the findings to the programs listed on the schedule of expenditures of federal awards. The 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 should be included. When information such as the CFDA title and number or federal award number is not available, the auditor should provide the best information available to describe the federal award.
- c. Each schedule of findings and questioned costs should include the following, where applicable, for each finding:
 - (1) *Reference Number*—Include a reference number to allow easy referencing of the audit finding during follow-up.
 - (2) *Criteria*—Identify the criteria, specific requirement, or expectation upon which the audit finding is based, including statutory, regulatory, or other citation (for example, the specific regulation not complied with).

- (3) *Statement of Condition*—Describe the condition found including facts to support the deficiency identified in the audit finding (for example, a regulation not followed).
- (4) *Questioned Costs*—Identify questioned costs and how they were computed.
- (5) *Perspective Information*—Include information to provide a 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, include the number and dollar amount of errors or exceptions in a sample and the number and dollar amount of the grants.
- (6) *Cause*—Describe what happened as a result of the condition. [Provide the auditee and federal agency or pass-through entity with enough information to permit them to determine the factor(s) that have created the difference between the identified *condition* and the desired state as defined by the *criteria*.]
- (7) *Effect or Potential Effect*—Provide a clear, logical link between the impact or potential impact of the difference between the *condition* and the *criteria*. The effect or potential effect identifies the outcomes of the condition and may demonstrate the need for corrective action.
- (8) *Recommendations*—Describe what the entity should do to correct the condition and to prevent future occurrences of the finding (for example, develop procedures to implement regulations).
- (9) *Response*—Report management's views and planned corrective actions (or, alternatively, refer to the corrective action plan) for findings related to federal awards in the federal awards section of the schedule of findings and questioned costs.

Some auditors prefer to combine certain items listed above. This practice is acceptable as long as the disclosures are sufficient and clearly relate the audit objectives to the findings.

- d. The schedule should not include names, social security numbers, any personal identification, or other potentially sensitive matters. (This information may be made available to the press and general public under the Freedom of Information Act.)
- e. If the auditor discovers that a recipient could have been reimbursed for more than was claimed, a "negative" finding should be reported (i.e., the entity should seek additional reimbursement).
- f. Audit findings (e.g., internal control matters, compliance findings, questioned costs, fraud, illegal acts, or abuse) that 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.

Views of Responsible Officials. The Yellow Book, at Paragraph 5.32, states that the auditor's report should include the views of responsible officials concerning the auditor's findings, conclusions, and recommendations, and what corrective actions are planned. (It is believed that inclusion in the schedule of findings and questioned costs as required by OMB Circular A-133 is the equivalent of inclusion in the "auditor's report.") Section 510(b)(8) of OMB Circular A-133 indicates the schedule of findings and questioned costs should include, to the extent practical, the entity's response when there is a disagreement with the audit findings. However, the Yellow Book indicates if the audited entity's comments oppose 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 the reasons for disagreeing with the comments or planned corrective actions. Footnote 25 to Paragraph 12.38 of the GAS/A-133 AICPA Audit Guide notes that the Yellow Book requirement subsumes (encompasses as a component unit) the OMB Circular A-133, Section 510(b)(8) requirement.

Relationship of Findings to Reports

Specific relationships between the auditor's reports on financial information, compliance with laws and regulations, internal control, and the number and nature of noncompliance findings cannot be established. Nevertheless, the auditor should consider the reasonableness of each of the reports in view of the reported findings.

Illustrated Schedules of Findings and Questioned Costs

Various formats are appropriate for the schedule of findings and questioned costs. Exhibit 1-6 and Exhibit 1-7 illustrate one method. Appendix A, Exhibit 12-6 of Chapter 12 of the GAS/A-133 AICPA Audit Guide also includes an illustrative schedule of findings and questioned costs. Other methods may be equally acceptable.

In addition to the formats illustrated in Exhibit 1-6 and Exhibit 1-7, another commonly used format for the summary of auditor's results allows the auditor to retain the components specified at Section 505(d)(1) of OMB Circular A-133 as a template while selecting/inserting the appropriate answer to each item, as illustrated in Exhibit 1-8. This format may be used with or without numbers at left identifying the applicable subsection within OMB Circular A-133.

Exhibit 1-8

Alternate Format—Summary of Auditor's Results

SUMMARY OF AUDIT RESULTS

Financial Statements

Type of auditor's report issued: [unqualified, qualified, adverse, OR disclaimer]

Internal control over financial reporting:

Material weakness(es) identified? [yes OR no]

Significant deficiencies identified that are not considered to be material weakness(es)?
[yes OR none reported]

Noncompliance material to financial statements noted? [yes OR no]

Federal Awards

Internal control over major programs:

Material weakness(es) identified? [yes OR no]

Significant deficiencies identified that are not considered to be material weakness(es)?
[yes OR none reported]

Type of auditor's report issued on compliance for major programs:

[unqualified, qualified, adverse, OR disclaimer (indicate type issued for each program)]

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133? [yes OR no]

Major programs:

[CFDA Number(s)]

[Name of Federal Program or Cluster]

Dollar threshold used to distinguish between type A and type B programs: \$_____

Auditee qualified as low-risk auditee? [yes OR no]

★

★

★

OTHER REPORTING MATTERS

Two-year Audits

Certain single audits may cover a two-year period. For audits covering a two-year period, the references to the audit period in the various reports should clearly disclose that fact. Terms such as "... the two years ended June 30, 20X2 ..." or "... the 20X1–X2 audit ..." may be used.

Comparative Financial Statements

While not as common as with for-profit entities, governmental and nonprofit organizations may nevertheless present comparative financial statements. As required in SAS No. 58, the auditor must, in these situations, report on both years presented. However, in these instances, neither the schedule of expenditures of federal awards nor the auditor's reports on internal control and compliance need cover, nor should they cover, the earliest year. A simple rule to remember is that if a single audit for the earliest year has already been performed and reported on, those reports should not be repeated.

Titles for Auditor's Reports

SAS No. 74 does not require auditors to title the Yellow Book or single audit reports. However, SAS No. 58 requires a title that includes the word "independent" for the auditor's standard report on the financial statements. This course suggests that Yellow Book and single audit reports also include a title.

Reporting Confidential or Sensitive Information

Certain information may be prohibited from general disclosure by federal, state, or local laws or regulations. In such circumstances, Paragraph 5.40 of the Yellow Book notes that auditors may issue a separate, classified, or limited-official-use report containing such information and distribute the report only to persons authorized by law or regulation to receive it. Additional circumstances associated with public safety and security concerns could also justify the exclusion of certain information in the report (e.g., detailed information related to computer security may be excluded from publicly available reports because of the potential damage that could be caused by the misuse of this information). In such circumstances, auditors may issue a limited-official-use report containing such information and distribute the report only to those parties responsible for acting on the auditors' recommendations. The auditors may, when appropriate, consult with legal counsel regarding any requirements or other circumstances that may necessitate the omission of certain information.

The Yellow Book, at Paragraph 5.42, states that:

Considering the broad public interest in the program or activity under review assists auditors when deciding whether to exclude certain information from publicly available reports. When circumstances call for omission of certain information, auditors should evaluate whether this omission could distort the audit results or conceal improper or illegal practices.

Paragraph 12.53 of the GAS/A-133 AICPA Audit Guide includes additional guidance relating to privileged and confidential information in recognition that auditors may need to exclude reporting certain sensitive information from publicly available reports.

American Recovery and Reinvestment Act of 2009 Considerations. Under the American Recovery and Reinvestment Act of 2009 (Recovery Act), the Federal Audit Clearinghouse (FAC) is required to make publicly available on the internet all single audit reports filed with the FAC for fiscal years ending September 30, 2009, and later. There will be a link from **www.recovery.gov** to the single audit reports. As this course went to press, it was unclear whether this new requirement applies to all single audit reports, or just those for entities that expend Recovery Act funds. Auditors should be aware that the entire reporting package, including the schedule of findings and questioned costs, may be publicly available due to this new Recovery Act requirement.

Report Retention Requirements

Section 320(g) of OMB Circular A-133 requires an auditee to 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 federal clearinghouse. Pass-through entities are required to keep subrecipients' submissions on file for three years from date of receipt.

Auditors should establish policies and procedures regarding the retention and safe custody of audit documentation. These policies should be for a time frame that meets the needs of the auditor's practice and considers any regulatory or legal requirements regarding document retention. SAS No. 103, *Audit Documentation*, establishes a longer period than OMB Circular A-133 does for retention of audit documentation. The SAS states that the retention

period for audit documentation “should not be shorter than five years from the report release date.” The Yellow Book does not provide a specific retention time period. However, because *Government Auditing Standards* incorporate the AICPA SASs, the minimum five-year retention period established by SAS No. 103 is applicable in a single audit.

Loss or Destruction of Audit Documentation—Effect on Report

Technical Practice Aid (TIS 8345.02) addresses the destruction of audit documentation by fire, flood, or natural disaster. It is believed the guidance also would apply if audit documentation is lost, deleted, or damaged due to other circumstances. The TPA indicates that if audit documentation is destroyed prior to the issuance of the auditor's report, the auditor must either recreate the audit documentation for the procedures performed or reperform the audit procedures and create new documentation. The auditor cannot issue a report indicating that he or she has performed an audit under professional standards without the required documentation. An auditor cannot use oral explanations as the principal support for the work that was performed.

When determining whether to recreate the documentation or reperform the procedures, the auditor should consider whether he or she will be able to demonstrate that sufficient competent evidential matter has been obtained to afford a reasonable basis for expressing an opinion on the financial statements. Except for very small engagements, it is believed it is unlikely that the auditor will be able to recreate sufficient documentation without reperforming at least some of the procedures.

The GAO also provided guidance for situations in which the auditor's documentation of a Yellow Book audit is lost or destroyed. The GAO states that if the auditor's work product is lost or destroyed after the audit was completed (or partially completed) but before the auditor's report is issued, the auditor will not meet the Yellow Book requirement that audit documentation “contain support for findings, conclusions, and recommendations before auditors issue their report.” The GAO states that the audit firm and the auditee will need to weigh the costs and benefits of recreating audit documentation or reperforming audit procedures with the need for public accountability. External oversight bodies should be consulted to determine whether there is a legal or regulatory requirement for the audit and, if so, how to meet the requirements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. Which of the following statements regarding the schedule of findings is most accurate?
- a. The findings should be organized by the auditee.
 - b. The findings should include the CFDA number.
 - c. The findings should include names, and social security numbers.
 - d. The findings should include a brief summary of the auditor's correction action plan.
36. Which of the following indicates that the schedule of findings should include the entity's response when there are disagreements with the audit report findings?
- a. Yellow Book.
 - b. OMB Circular A-133.
37. OMB Circular A-133 does not require the auditor to _____ in regards to reporting findings in the federal awards section of the schedule of findings and questioned costs.
- a. Make an additional report when the auditor confirms that the fraud was reported outside of his or her reports under the direct reporting requirements of GAGAS.
 - b. Determine whether a deficiency in internal control is significant.
 - c. Determine whether a noncompliance with the provisions of laws is material for reporting an audit finding is in relation to a type of compliance.
38. Section 505(d)(2) of OMB Circular A-133 requires the schedule of findings and questioned costs to include a section that reports findings relating to the financial statements. Which of the following is a finding to be included in the financial statement section?
- a. Material violations of provisions of contracts.
 - b. A statement that significant deficiencies were disclosed by the audit of the financial statements.
 - c. A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee.
 - d. Identification of major programs.
39. Section 505(d)(2) of OMB Circular A-133 requires the schedule of findings and questioned costs to include a section that reports findings relating to the financial statements. Which of the following is another finding related only to the financial statements?
- a. A compliance report issued for each major program.
 - b. A report on significant deficiencies that are material weaknesses in internal control over financial reporting.
 - c. A report issued by the auditor on the financial statements of the auditee.

40. How does OMB Circular A-133 Section 105 define questioned costs?
- a. A cost questioned by the auditor because of an audit finding where costs are not supported by adequate documentation at the time of the audit.
 - b. A finding that such cost is not supported by adequate documentation at the time of the audit.
 - c. An alleged violation of a provision of law governing the expenditure of funds.
 - d. A finding that the expenditure of funds for the intended purpose is unreasonable.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. Which of the following statements regarding the schedule of findings is most accurate? **(Page 383)**
- a. The findings should be organized by the auditee. [This answer is incorrect. The findings should be organized by federal programs so the reader can readily relate the findings to the programs listed on the schedule of expenditures of federal awards.]
 - b. The findings should include the CFDA number. [This answer is correct. The 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 should be included.]**
 - c. The findings should include names, and social security numbers. [This answer is incorrect. The schedule should not include names, social security numbers, any personal identification, or other potentially sensitive matters. (This information may be made available to the press and general public under the Freedom of Information Act.)]
 - d. The findings should include a brief summary of the auditor's correction action plan. [This answer is incorrect. The 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.]
36. Which of the following indicates that the schedule of findings should include the entity's response when there are disagreements with the audit report findings? **(Page 384)**
- a. Yellow Book. [This answer is incorrect. The Yellow Book indicates if the audited entity's comments oppose 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 the reasons for disagreeing with the comments or planned corrective actions.]
 - b. OMB Circular A-133. [This answer is correct. Section 510(b)(8) of OMB Circular A-133 indicates the schedule of findings and questioned costs should include, to the extent practical, the entity's response when there is a disagreement with the audit findings.]**
37. OMB Circular A-133 does **not** require the auditor to _____ in regards to reporting findings in the federal awards section of the schedule of findings and questioned costs. **(Page 375)**
- a. Make an additional report when the auditor confirms that the fraud was reported outside of his or her reports under the direct reporting requirements of GAGAS. [This answer is correct. 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 should be reported as findings in the federal awards section of the schedule of findings and questioned costs. OMB Circular A-133 does not require the auditor to make an additional report when the auditor confirms that the fraud was reported outside of his reports under the direct reporting requirements of GAGAS.]**
 - b. Determine whether a deficiency in internal control is significant. [This answer is incorrect. 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 an audit objective identified in the Compliance Supplement. The auditor should identify significant deficiencies which are individually or cumulatively material weaknesses.]
 - c. Determine whether a noncompliance with the provisions of laws is material for reporting an audit finding is in relation to a type of compliance. [This answer is incorrect. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for

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.]

38. Section 505(d)(2) of OMB Circular A-133 requires the schedule of findings and questioned costs to include a section that reports findings relating to the financial statements. Which of the following is a finding to be included in the financial statement section? **(Page 375)**

- a. **Material violations of provisions of contracts. [This answer is correct. The financial statement section on the schedule of findings and questioned costs should include material violations of provisions of contracts and grant agreements. Material abuse should also be included in the financial statement section on the schedule of findings and questioned costs.]**
- b. A statement that significant deficiencies were disclosed by the audit of the financial statements. [This answer is incorrect. A statement that significant deficiencies in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses, as required to be reported in accordance with Government Auditing Standards should be included in the schedule of findings and questioned costs but not in the financial statement section.]
- c. A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee. [This answer is incorrect. A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee, as required to be reported in accordance with *Government Auditing Standards* should be included in the schedule of findings and questioned costs but not in the financial statement section.]
- d. Identification of major programs. [This answer is incorrect. An identification of major programs should be included in the schedule of findings and questioned costs but not in the financial statement section.]

39. Section 505(d)(2) of OMB Circular A-133 requires the schedule of findings and questioned costs to include a section that reports findings relating to the financial statements. Which of the following is another finding related only to the financial statements? **(Page 375)**

- a. A compliance report issued for each major program. [This answer is incorrect. The type of report the auditor issued on compliance for each major program (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion) is required by Section 505(d) of OMB Circular A-133 should be included in the scheduled of findings and questioned cost, but not in the findings related to the financial statements.]
- b. **A report on significant deficiencies that are material weaknesses in internal control over financial reporting. [This answer is correct. All significant deficiencies and significant deficiencies that are material weaknesses in the internal control over financial reporting should be included only in the finding related to the financial statements.]**
- c. A report issued by the auditor on the financial statements of the auditee. [This answer is incorrect. This type of report is required by Section 505(d) of OMB Circular A-133 should be included in the scheduled of findings and questioned cost, but not in the findings related to the financial statements.]

40. How does OMB Circular A-133 Section 105 define questioned costs? **(Page 383)**

- a. **A cost questioned by the auditor because of and audit finding where costs are not supported by adequate documentation at the time of the audit. [This answer is correct. Section 105 of OMB Circular A-133 defines questioned cost as a cost that is questioned by the auditor because of an audit finding that resulted from a 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; and where the costs incurred appear unreasonable and do not reflect the actions of a prudent person in these circumstances.]**

- b. A finding that such cost is not supported by adequate documentation at the time of the audit. [This answer is incorrect. The Inspector General Act Amendments of 1988, not OMB Circular A-133 Section 105, defines questioned cost as a finding that, at the time of the audit, such cost is not supported by adequate documentation.]
- c. An alleged violation of a provision of law governing the expenditure of funds. [This answer is incorrect. The Inspector General Act Amendments of 1988, not OMB Circular A-133, Section 105, defines questioned cost as an alleged violation of a provision of law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds.]
- d. A finding that the expenditure of funds for the intended purpose is unreasonable. [This answer is incorrect. The Inspector General Act Amendments of 1988, not OMB Circular A-133 Section 105, defines questioned costs as a finding that the expenditure of funds for the intended purpose is unnecessary or unreasonable.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (GSATG093)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

14. Lucy is performing a GAAS financial audit on Ricardo's Used Instruments, Inc. Which of the following is one report Lucy is required to issue?
 - a. Report on internal control over financial reporting.
 - b. Report on schedule of expenditures.
 - c. Report on written communication of significant deficiencies.
 - d. Report on compliance with laws and regulations.
15. The GAS/A-133 AICPA Audit Guide recommends issuing three reports related to a Single Audit. Which of the following is **not** one of the reports recommended?
 - a. A report on compliance with laws, regulations, contracts, and grant agreements, and other matters at the financial statement level.
 - b. One Single Audit major program report including a report on internal control and an opinion on compliance.
 - c. One Yellow Book report addressing internal control over financial reporting and compliance.
 - d. An opinion on the financial statements, including a SAS No. 29 opinion on the schedule of expenditures of federal awards.
16. How many reporting packages must the auditee submit to the pass-through entity when there are no current or prior audit findings?
 - a. None.
 - b. One copy of the reporting package is required.
 - c. Two copies of the reporting package are required.
 - d. Three copies of the reporting package are required.
17. Are auditors/auditees required to bind together the audit reports before submitting them to the appropriate agency?
 - a. Yes.
 - b. No.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.

18. It is the auditor's responsibility to report on all the information in documents containing audited financial statements that they submit to clients or others. What action is required if a reporting package is considered auditor-submitted?
- a. None. The auditor has no additional responsibility for the information that accompanies the financial statements.
 - b. The auditor should clearly indicate that the schedules that are unaudited.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.

19. The following paragraph is added after the opinion paragraph of the report of the financial statements, referring the reader to the report on internal control and compliance. Which of the following sentences of the paragraph is a Yellow Book requirement?

In accordance with Government Auditing Standards, we have also issued our report dated [Date] on our consideration of [Name of Governmental Entity or Nonprofit Organization]'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 an opinion 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 important for assessing the results of our audit.

- a. In accordance with Government Auditing Standards, we have also issued our report dated [Date] on our consideration of [Name of Governmental Entity or Nonprofit Organization]'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.
 - b. 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.
 - c. 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.
 - d. No portion of the paragraph is a Yellow Book requirement.
20. Which of the following organizations can present their financial statements on a basis of accounting other than GAAP?
- a. Nonprofit.
 - b. Governmental.
 - c. Both.
 - d. Do not select this answer choice.

21. *Government Auditing Standards* require that the auditor's standard report on internal control over financial reporting and on compliance and other matters report include a statement that the auditor has audited the financial statements. Any departure from the standard report, including qualified or adverse opinions, disclaimers of opinion, and explanatory language, has to be described in the Yellow Book report. In the audit reports included in the GAS/A-133 AICPA Audit Guide, these disclosures are only required in which portion of the paragraph of the report on internal control over financial reporting on compliance and other matters required by the Yellow Book?
- a. Introductory paragraph.
 - b. Opinion paragraph.
 - c. Next to last paragraph.
 - d. Last paragraph.
22. Which of the following types of financial statements are more likely to be comparative?
- a. Governmental unit financial statements.
 - b. Financial statements for nonprofit organizations.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
23. Sam is preparing and reporting on the schedule of expenditures of federal awards of Citywide Nonprofit Organization. As a general rule, the more information included in the schedule, the fewer follow-up calls from federal agencies. However, not all information included on the list is required. Which of the following is *Bea* required to be included in the schedule?
- a. The subgrant awards numbers assigned by pass-through entities.
 - b. Nonfederal expenditures.
 - c. Administrative cost allowance received under a federal loan.
 - d. Financial information for the schedule taken from the entity's records.
24. Which of the following is an example of a note disclosing expenditures exceeding contract or grant amounts?
- a. During the year ended (date), funds totaling \$20,000 were received from (name of grantor—often a state department). While the grant agreement indicates that the source of the funds includes both federal (CFDA XX.XXX) and state awards, the (grantor) has not provided the organization with the amount of federal funds included. Because the federal portion of the expenditures is unknown, the full amount is included in the accompanying schedule of expenditures of federal awards.
 - b. Expenditures on the (name of project) exceeded the award amount by \$20,000. The excess, which is not included in the expenditure amount on the accompanying schedule of expenditures of federal awards, was (explain reason for excess cost). The (name of entity) plans to bill the (name of grantor) for the excess (explain why the amount should be billed to the grantor).
 - c. In accordance with terms of the grant, program income totaling \$20,000 was used to reduce the amount of federal funds used to complete the project.

25. "The report should state that the audit has been made for the purpose of forming an opinion on the basic financial statements taken as a whole," is a basic requirement for which of the following reports?
- A report on additional information accompanying the basic financial statements in an auditor-submitted document.
 - A report on internal control over financial reporting and on compliance and other matters based on an audit of the financial statements of a governmental unit and nonprofit organization.
 - A report on significant deficiencies when some are material weaknesses.
 - A report when material noncompliance findings are identified.
26. GAS/A-133 of the AICPA Audit guide recommends that the illustrative auditor's reports in the GAS/A-133 AICPA Audit Guide combine the report on the schedule of expenditures of federal awards with the report on the financial statements. If the schedule is not presented with the financial statements, what other report may be used?
- A report on material noncompliance findings.
 - A report on additional information accompanying the basic financial statements in an auditor-submitted document.
 - A report on significant deficiencies when some are material weaknesses.
 - The report on compliance and on internal control required by OMB Circular A-133.
27. When auditors' procedures lead them to believe that the schedule information is materially misstated in relation to the basic financial statements taken as a whole, the auditor should discuss any reservations with the client and propose that the information be corrected. What should the auditor do if the client refuses to correct the information?
- Consult with an attorney.
 - Issue an unqualified opinion.
 - Issue a qualified opinion.
 - Issue a disclaimer of opinion.
28. Auditors should consider the _____ when evaluating significant matters that may arise during the audit of the schedule of expenditures of federal awards.
- Reasonableness of each of the reports.
 - Professional requirements.
 - Impact on the audit reports.
 - Do not select this answer choice.
29. What is the difference between a significant deficiency and a material weakness?
- The reporting requirements.
 - The magnitude of the noncompliance that could have occurred.
 - The effect of subsequent events.
 - The effect on financial statements.

30. This course contains a list of criteria that may be helpful when determining if a finding is material. Which of the following is **not** on that list?
- a. The scope of testing of internal control.
 - b. Results of prior audits.
 - c. Level and extent of review or other forms of independent oversight.
 - d. Monetary value of the questioned cost.
31. An auditee is responsible for which of the following?
- a. Acknowledge the involvement of other auditors.
 - b. Preparing a schedule of findings and questioned costs.
 - c. Evaluating the timeliness and appropriateness of management's actions.
 - d. Following up and taking corrective action on all audit findings.
32. Paragraph 12.41 of the GAS/A-133 AICPA Audit Guide indicates that if there are no prior findings to report on, the auditee is **not** required to prepare a summary schedule.
- a. True.
 - b. False.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
33. Which of the following statements regarding control deficiencies is most accurate?
- a. The auditor should always consider if a misstatement has occurred when control deficiencies are identified.
 - b. Generally, the absence of identified misstatements indicates that control deficiencies are not significant deficiencies or material weaknesses.
 - c. If an auditor identifies control deficiencies, he or she can withdraw from the engagement.
 - d. The term "more than a remote likelihood" is used as thresholds by SAS No. 112 when determining whether the likelihood and magnitude, respectively, of a control deficiency result in a significant deficiency.
34. According to Section 505(d)(1)(ii) and (iv) of OMB Circular A-133, all material weaknesses and significant deficiencies should be reported in which of the following?
- a. Schedule of findings and questioned costs.
 - b. Summary schedule of prior audit findings.
 - c. Yellow Book report on internal control over financial reporting and on compliance and other matters.
 - d. Corrective action plan.

35. Management letters should be used to communicate which of the following?
- a. Matters that are inconsequential.
 - b. Matters not required to be included in the auditor's reports.
 - c. Recommendations for improving internal controls.
 - d. Recommendations for operational efficiencies.
36. The schedule of findings and questioned costs should include all of the following **except**:
- a. Audit results summary.
 - b. Internal control matters not considered to be significant deficiencies.
 - c. Material instances of noncompliance.
 - d. Significant deficiencies.
37. The auditor should report known questioned costs when likely questioned costs are greater than _____ for a type of compliance requirement for a major program.
- a. \$10,000.
 - b. \$20,000.
 - c. \$25,000.
 - d. \$30,000.
38. Findings that do not involve federal funds generally should be included in which of the following?
- a. Schedule of findings.
 - b. Engagement letter.
 - c. Questioned costs.
 - d. Separate schedule.
39. How long is a pass-through entity required to retain subrecipient's submissions on file?
- a. 90 days.
 - b. One year.
 - c. Two years.
 - d. Three years.
40. What should an auditor do if audit documentation is lost prior to the issuance of the auditor's report?
- a. Use oral explanations as the principal support for the work performed.
 - b. Reperform the audit procedures and create new documentation.
 - c. Issue a written report indicating the audit documentation was performed under professional standards without required documentation.
 - d. Do not select this answer choice.

GLOSSARY

Audit Report Date: Represents the date that the auditor has obtained sufficient appropriate evidence to support his or her opinions on the financial statements and on compliance.

Commitments: Commitments are contractual obligations for a future expenditure.

Contingencies: Contingencies are existing conditions that create a current obligation that needs to be accrued or that might create an obligation in the future that needs to be disclosed.

Data Collection Form: To streamline the distribution of audit reports and improve the government-wide collection and analysis of single audit results, Section 320 of OMB Circular A-133 provides for a form, referred to as the data collection form, to be prepared at the completion of each audit and submitted to the federal clearinghouse designated by the OMB. The form provides key information about the non-federal entity, the federal awards it administers, whether the audit was completed in accordance with OMB Circular A-133, and the audit results.

Documentation Completion Date: SAS No. 103 indicates that the final assembly and completion of the audit file should occur within 60 days of the report release date. SAS No. 103 refers to this date as the documentation completion date.

Material Weakness: 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.

Questioned Costs: Question costs are costs the auditor believes may not comply with or be consistent with the requirements set forth in contracts, laws, statutes, or regulations governing the allocability, allowability, or reasonableness of costs charged to federal programs and, thus, may not be reimbursable.

Report Release Date: The report release date is the date that the auditor gives the client permission to use the auditor's reports.

SAS No. 85, Management Representations: Requires the auditor to obtain written representations from responsible client officials.

SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit: Establishes standards and provides guidance on communicating matters related to internal control over financial reporting in financial statement audits.

Significant Deficiency: 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.

Uncertainty: A matter that is expected to be resolved at a future date, at which time conclusive audit evidence concerning its outcome would be expected to become available.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPCs Guide to Single Audits—Course 1—Compliance Auditing, Subrecipient Considerations, and Program-specific Audits (GSATG091)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET**Companion to PPC's Guide to Single Audits—Course 1—Compliance Auditing,
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6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET**Companion to PPC's Guide to Single Audits—Course 2—Planning the Single Audit and
Single Audit Sampling (GSATG092)****Price \$75**

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add \$24.95

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ☒ not like this ☐ ☐ ☒.

a	b	c	d	a	b	c	d	a	b	c	d	a	b	c	d
1. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	11. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	21. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	31. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	12. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	22. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	32. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	13. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	23. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	33. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	14. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	24. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	34. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	15. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	25. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	35. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	16. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	26. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	36. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	17. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	27. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	37. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	18. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	28. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	38. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	19. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	29. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	39. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	20. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	30. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	40. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: July 31, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Single Audits—Course 2—Planning the Single Audit and Single Audit Sampling Course Acronym: GSATG092

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ☒ not like this ☐ ☐ ☒.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

- What did you find **most** helpful? _____
- What did you find **least** helpful? _____
- What other courses or subject areas would you like for us to offer? _____
- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
- How many employees are in your company? _____
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No** ☐ ☐

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Single Audits—Course 3—Concluding the Single Audit and Reporting under the Single Audit (GSATG093)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
GSATG093 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700**

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

Please allow a minimum of three weeks for grading.

Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of \$75. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is \$214 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$270 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$319 (a 15% discount on all five courses or more).
4. To receive CPE credit, completed answer sheets must be postmarked by **July 31, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional \$24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.
5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.
6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Single Audits—Course 3—Concluding the Single Audit and Reporting under the Single Audit (GSATG093)

Price \$75

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add \$24.95

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○ ⊗ ⊙ .

a	b	c	d	a	b	c	d	a	b	c	d	a	b	c	d
1. ○	○	○	○	11. ○	○	○	○	21. ○	○	○	○	31. ○	○	○	○
2. ○	○	○	○	12. ○	○	○	○	22. ○	○	○	○	32. ○	○	○	○
3. ○	○	○	○	13. ○	○	○	○	23. ○	○	○	○	33. ○	○	○	○
4. ○	○	○	○	14. ○	○	○	○	24. ○	○	○	○	34. ○	○	○	○
5. ○	○	○	○	15. ○	○	○	○	25. ○	○	○	○	35. ○	○	○	○
6. ○	○	○	○	16. ○	○	○	○	26. ○	○	○	○	36. ○	○	○	○
7. ○	○	○	○	17. ○	○	○	○	27. ○	○	○	○	37. ○	○	○	○
8. ○	○	○	○	18. ○	○	○	○	28. ○	○	○	○	38. ○	○	○	○
9. ○	○	○	○	19. ○	○	○	○	29. ○	○	○	○	39. ○	○	○	○
10. ○	○	○	○	20. ○	○	○	○	30. ○	○	○	○	40. ○	○	○	○

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Expiration Date: July 31, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Single Audits—Course 3—Concluding the Single Audit and Reporting under the Single Audit Course Acronym: GSATG093

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ○ × ○.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

- What did you find **most** helpful? _____
- What did you find **least** helpful? _____
- What other courses or subject areas would you like for us to offer? _____
- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
- How many employees are in your company? _____
- May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. Yes/No ☐ ☐

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