GSAT17

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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

Companion to PPC's Guide to 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 **cl.thomsonreuters.com/ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **September 30, 2018**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit.

Taking the Courses

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 at the end of the course**. You may either record your answer choices on the **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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Checkpoint Learning is also approved for "QAS Self Study" designation.

The requirements for NASBA Registry membership include conformance with the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. Each course is designed to comply with the *Standards*. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that 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 **cl.thomsonreuters.com/ogs** 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 of $89 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**. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Print Grading. You can receive CPE credit by emailing, mailing, or faxing your completed **Examination for CPE Credit Answer Sheet** to Thomson Reuters (Tax & Accounting) Inc. for grading. Answer sheets are located at the end of all course materials. Answer sheets may be printed from electronic products; they can also be scanned for email grading, if desired. The answer sheet is identified with the course acronym. Please ensure you use the correct

answer sheet for each course. Payment (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Payment for emailed or faxed answer sheets is $89. There is an additional $10 charge for manual print grading, so please include a total of $99 with answer sheets sent by regular mail. Please take a few minutes to complete the **Self-study Course Evaluation** so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation** to **(888) 286-9070** or email them to *CPLGrading@thomsonreuters.com*. The mailing address is provided on the Overview and Exam Instructions pages.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment must accompany each answer sheet submitted ($89 when sent by email or fax; $99 when sent by regular mail). We would also appreciate a separate **Self-study Course Evaluation** from each person who completes an examination.

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For all scores of 70% or higher, you will receive a *Certificate of Completion.* You should retain it and a copy of these materials for at least five years.

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COMPANION TO PPC'S GUIDE TO SINGLE AUDITS

COURSE 1

CONCLUDING THE SINGLE AUDIT AND REPORTING UNDER THE SINGLE AUDIT(GSATG171)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses the general procedures for concluding an audit and how reports are issued in a single audit.

PUBLICATION/REVISION DATE: September 2017

RECOMMENDED FOR: Users of *PPC's Guide to Single Audits*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of governmental auditing

CPE CREDIT: 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

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 **September 30, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Concluding the Single Audit

Completion of this lesson will enable you to:

- Identify commitments and contingencies, the purpose and requirements of a management representation letter, and how accumulated results of audit procedures are determined.
- Recognize how workpapers are reviewed, how to evaluate the overall results of audit tests, how to draft the financial statements, and how to submit the data collection form.
- Identify the requirements for an exit conference and certain client communications, as well as requirements for workpaper finalization, access, and retention.

Lesson 2—Reporting under the Single Audit

Completion of this lesson will enable you to:

- Recognize how to address, date, and submit an auditor's report, and identify the various audit reports that are unique to Uniform Guidance compliance audits.

- Identify the requirements for reporting on internal control over financial reporting and on compliance as required by Government Auditing Standards, and how to prepare and report on the schedule of expenditures of federal awards.
- Recognize compliance reporting requirements applicable to each major program and internal control as required by Uniform Guidance, and how to prepare a summary schedule of prior audit findings.
- Identify the GAAS requirements for reporting fraud, noncompliance, and abuse, and the auditor's reporting and communications responsibilities under Government Auditing Standards and Uniform Guidance with respect to control deficiencies.
- Recognize what is included in the schedule of findings and questioned costs as well as rules for other reporting matters.

TO COMPLETE THIS LEARNING PROCESS:

Submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
- Fax to: **(888) 286-9070**
- Mail to:

Thomson Reuters
Tax & Accounting—Checkpoint Learning
GSATG171 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

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

ADMINISTRATIVE POLICIES:

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Lesson 1: Concluding the Single Audit

INTRODUCTION

In addition to the audit procedures specifically related to the Uniform Guidance compliance audit (e.g., procedures related to compliance and internal controls over compliance), some other procedures that are of a general nature are necessary in a single audit. The general procedures that are discussed in this lesson are as follows:

- Procedures to search for *commitments and contingencies*, including obtaining lawyers' letters.
- Procedures related to the consideration of subsequent events.
- Obtaining written representations from management in 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 should summarize and evaluate the overall results of audit procedures; complete the auditor's portion of the data collection form; reach a conclusion on the form of the opinion on the financial statements, the in-relation-to opinion on the schedule of expenditures of federal awards, and the opinion on major program compliance; reach a conclusion on findings relating the Yellow Book reporting on internal control over financial reporting and internal control over compliance; and communicate those opinions, findings, and other significant matters in written and oral reports. The auditor is also subject to certain requirements for workpaper finalization and retention. In addition, if the auditor discovers certain matters subsequent to the date of the report, professional standards outline certain procedures that should be performed. These audit requirements and considerations for workpaper finalization, access, and retention are also discussed in this lesson. Lesson 2 discusses the reports that are issued in a single audit.

Authoritative Literature

The authoritative pronouncements that establish requirements or provide suggestions that most directly affect the general procedures discussed in this lesson include the following:

- AU-C 230, *Audit Documentation*.
- AU-C 240, *Consideration of Fraud in a Financial Statement Audit*.
- AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.
- AU-C 260, *The Auditor's Communication with Those Charged with Governance*.
- AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.
- AU-C 300, *Planning An Audit*, and AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.
- AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.
- AU-C 450, *Evaluation of Misstatements Identified During the Audit*.
- AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*.
- AU-C 560, *Subsequent Events and Subsequently Discovered Facts*.
- AU-C 580, *Written Representations*.
- AU-C 585, *Consideration of Omitted Procedures After the Report Release Date*.

- AU-C 935, *Compliance Audits*.
- Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance).
- AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide).
- GAO *Government Auditing Standards, 2011 Revision* (Yellow Book).

Learning Objectives:

Completion of this lesson will enable you to:
- Identify commitments and contingencies, the purpose and requirements of a management representation letter, and how accumulated results of audit procedures are determined.
- Recognize how workpapers are reviewed, how to evaluate the overall results of audit tests, how to draft the financial statements, and how to submit the data collection form.
- Identify the requirements for an exit conference and certain client communications, as well as requirements for workpaper finalization, access, and retention.

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 federal statutes, regulations, and the terms and conditions of 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 awarding 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.
- Reviewing legal expenses and invoices and correspondence from lawyers.
- Sending a letter of inquiry to legal counsel.

Litigation, Claims, and Assessments

AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, requires the auditor to design and perform audit procedures to identify an entity's litigation, claims, and assessments that may result in a risk of material misstatement. AU-C 501 provides specific procedures for such identification as well as requirements for actual or potential litigation, claims, and assessments that the auditor identifies.

AU-C 501.18 requires the auditor to seek direct communication with the entity's legal counsel through a letter of inquiry prepared by management unless the procedures performed to identify litigation, claims, and assessments do not indicate any actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement. Smaller entities generally engage outside legal counsel for all litigation, claims, and assessments. However, communication is also required from in-house legal counsel (if any) when the entity's in-house legal counsel has responsibility for the entity's litigation, claims, and assessments. In such circumstances, in-house legal counsel may be in the best position to know and describe the status of litigation, claims, and assessments or to corroborate the information provided by management. In the situation where the auditor does not seek direct communication with the entity's legal counsel, AU-C 501.20 states that the auditor should document the basis for that decision.

The letter should request legal counsel to inform the auditor of any litigation, claims, assessments, and unasserted claims that counsel is aware of, an assessment of the outcome, and an estimate of the financial implications (including costs involved). The auditor might also consider inquiring about demands for repayment of federal funds due to violations of grant requirements. If a request for legal representation is not sent, information related to demands for repayment of federal funds can be obtained through discussions with management and the cognizant or oversight agency for audit.

If a request for legal representation is sent, the letter from the client's lawyer needs to be coordinated with the date of the auditor's report. Accordingly, it is preferable for the letter to be dated to cover a period that closely corresponds to the auditor's report date, usually within two weeks of the report date. If the attorney's response does not specify an effective date, the auditor can assume that the date of the response is the effective date. If the lawyer's response is dated too long before the date of the auditor's report, the auditor needs to consider getting an updated response. In addition, if 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 purposes of 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, best practices indicate that the auditor obtain a written representation from management stating that the organization has not consulted with an attorney.

SUBSEQUENT EVENTS

AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, defines the types of subsequent events the auditor should evaluate and specifies the procedures that should be performed to determine the occurrence of such events.

Subsequent Events Related to the Schedule of Expenditures of Federal Awards

AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, provides guidance on the auditor's responsibilities when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. AU-C 725.08 explains that the auditor has no responsibility for the consideration of subsequent events with respect to the schedule of expenditures of federal awards. However, if information comes to the auditor's attention (a) prior to the release of the auditor's report on the entity's financial statements regarding subsequent events that affect the financial statements, or (b) subsequent to the release of the auditor's report on the financial statements regarding facts that, if known to the auditor at the date of the report, may have caused the auditor to revise the report, the auditor should apply the relevant requirements in AU-C 560.

Subsequent Events Related to Compliance

In a Uniform Guidance compliance audit, the auditor's responsibilities regarding subsequent events are similar to those in a financial statement audit except that the events being considered relate to direct and material compliance requirements. Two types of subsequent events require consideration by management and evaluation by the auditor in a compliance audit: (a) events that provide additional information about conditions that existed at the end of the reporting period that affect compliance during the reporting period and (b) events of noncompliance that did not exist at the end of the reporting period but occurred subsequent to the reporting period and before the date of the auditor's report.

AU-C 935.25, *Compliance Audits*, states that subsequent events procedures should be performed up to the date of the auditor's report. The nature and extent of such procedures should take into account the auditor's risk assessment and should include, but not be limited to, inquiring of management about and considering the following:

- Relevant reports issued by internal auditors during the subsequent period.
- Reports issued by other auditors during the subsequent period that identify noncompliance.
- Reports on the entity's noncompliance that were issued by federal awarding agencies and pass-through entities during the subsequent period.
- Information about noncompliance obtained through other professional engagements performed for that entity.

AU-C 935.27 explains that the auditor is not required to perform audit procedures related to noncompliance that occurs after the period covered by the auditor's report. However, the auditor should discuss with management and, if appropriate, those charged with governance any such noncompliance that comes to the auditor's attention before the report release date if, due to its nature and significance, disclosure of the noncompliance is necessary to keep the report from being misleading. An example of such a matter might be noncompliance occurring in the subsequent period that was so significant the federal awarding agency stopped funding the program. The auditor's report should include an other-matter paragraph describing the nature of such noncompliance. The GAS/SA Audit Guide, Paragraph 10.49, provides similar guidance.

WRITTEN REPRESENTATIONS

AU-C 580, *Written Representations*, at AU-C 580.09, requires the auditor to request written representations from management with appropriate responsibilities for the financial statements, as well as knowledge of the related matters, as part of an audit performed in accordance with generally accepted auditing standards. 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.

AU-C 580.26 further indicates that when management does not provide one or more of the written representations requested, the auditor should, (a) discuss the omission with management, (b) reevaluate management's integrity,

(c) evaluate the implications for the reliability of management's other written or oral representations and evidence generally, and (d) take appropriate actions.

Appropriate actions include determining the possible impact to the auditor's report pursuant to the guidance provided by AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report.* The inability to obtain written representations is a scope limitation that prevents the auditor from expressing an unmodified opinion. When those representations are either (a) not provided by management, or (b) the auditor cannot rely on the representations due to the auditor concluding that sufficient doubt exists about management's integrity, AU-C 580.25 requires the auditor to disclaim an opinion or withdraw from the engagement. According to AU-C 580.A34, depending on the reasons for the refusal or the nature of the omitted representations, the auditor may determine that a qualified opinion is appropriate.

Periods Covered by the Letter

AU-C 580 requires written representations from management who have responsibility for the financial statements and knowledge of the matters concerned 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.

AU-C 580.A26 explains that even when current management was not present during all periods referred to in the auditor's report, current management's responsibilities for the financial statements as a whole and the schedule of expenditures of federal awards are not diminished and the requirement for the auditor to request from them written representations that cover the whole of the relevant periods still applies. Best practices indicate the auditor has to insist on written representations from management with appropriate responsibilities for the financial statements and the schedule of expenditures of federal awards and knowledge of the matters concerned. The only reason for not requesting representations would be that the position the person holds is not responsible for the financial statements and/or the schedule of expenditures of federal awards. Auditors may point out that the letter limits the confirmant's response to his or her best knowledge and belief.

Written Representations to Be Obtained

While a representation letter is usually prepared by an auditor, it is a communication from the client to the auditor and is signed by client management. The representation letter acknowledges management's primary responsibility for the financial statements, even if the auditor drafts or assists with drafting the financial statements and related notes. Additionally, the representations obtained from management provide other audit evidence and support the validity of results of audit procedures performed. AU-C 580.10–.18 provides a list of specific representations that should be obtained. Even though certain written representations are specifically required, other authoritative pronouncements also require representations.

The auditor's analysis and summary of instances of noncompliance and audit differences as well as evaluation of their materiality at the end of the audit are discussed later in this lesson. AU-C 580.14 requires written representations from management about uncorrected misstatements. It 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 request written representations from management. However, the auditor cannot simply accept management's representations as the only necessary audit evidence for the matters included in the representation letter. If the auditor cannot verify a representation using another form of evidence (for example, that management has no plans or intentions that may materially affect the carrying value or classification of assets, liabilities, or equity), the auditor needs to evaluate whether the representation is feasible considering factors such as:

- Whether the client has carried out its stated intentions in the past.

- The entity's ability to pursue a specific course of action.
- Whether any conflicting information has been learned during the course of the audit that seems inconsistent with management's judgment or intent.

Additionally, if the auditor becomes concerned about management's competence, integrity, ethical values, or diligence, the auditor should determine the effect that those concerns may have on the reliability of management's representations (oral or written) and audit evidence in general. Significant concerns in this area may cause the auditor to conclude that the risk of management misrepresentation is such that an audit cannot be conducted. According to AU-C 580.A30, even when those charged with governance implement appropriate corrective measures, such measures may not be enough to enable the auditor to issue an unmodified audit opinion.

In particular, if other audit evidence contradicts a representation made by management, AU-C 580.23 indicates that the auditor should attempt to resolve the matter by performing audit procedures. In the case of such identified contradictions, the auditor may consider whether the risk assessment remains appropriate, and if not, may revise the risk assessment and perform appropriate procedures to respond to the assessed risks.

In the situation where the auditor concludes that the written representations are unreliable, the auditor should take appropriate action, including determining any effect on the auditor's report. AU-C 580.25 indicates that the auditor should disclaim an opinion on the financial statements or withdraw from the engagement if the auditor determines that sufficient doubt exists about management's integrity and the reliability of the written representations required by AU-C 580.10–.11. The possible effects on the financial statements of an inability to rely on the written representations required by AU-C 580.10–.11 are not limited to specific elements, accounts, or items of the financial statements and thus, are pervasive.

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 AU-C 580 (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 AU-C 580, 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.

Financial Statement Audit. Paragraph 3.67 of the GAS/SA Audit Guide indicates that with respect to the financial statement audit performed under GAAS and the Yellow Book, it might be appropriate to obtain additional representations from management acknowledging that:

- Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
- Management is responsible for compliance with the laws, regulations, and provisions of contracts and grant agreements applicable to the auditee.
- Management has identified and disclosed to the auditor all instances, that have occurred or are likely to have occurred, of fraud and noncompliance with provisions of laws and regulations that have a material effect on the financial statements, and any other instances that warrant the attention of those charged with governance.
- Management has identified and disclosed to the auditor all instances, that have occurred or are likely to have occurred, of noncompliance with provisions of contracts and grant agreements that has a material effect on the determination of financial statement amounts.
- Management has identified and disclosed to the auditor all instances that have occurred or are likely to have occurred, of abuse that could be quantitatively or qualitatively material to the financial statements.
- Management is responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

- Management is responsible for the design, implementation, and maintenance of internal controls to prevent and detect fraud.
- 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, noncompliance with provisions of laws, regulations, contracts, and 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 audits, attestation engagements, and other studies related to the audit objectives and whether related recommendations have been implemented.
- Management has provided views on the auditors' reported findings, conclusions, and recommendations, as well as management's planned corrective actions, for the report.
- Management acknowledges its responsibilities as they relate to nonaudit services performed by the auditor, including that management assumes all management responsibilities; oversees the services by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, or experience; evaluates the adequacy and results of the services performed; and accepts responsibility for the results of the services.

Compliance Audit. In a Uniform Guidance compliance 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. AU-C 935.23 and Paragraph 10.76 of the GAS/SA Audit Guide list the following written representations the auditor should consider obtaining from management in a compliance audit. The representations should be tailored for the entity and a single audit and include the following:

- Management is responsible for complying, and has complied, with the requirements of the Uniform Guidance.
- Management is responsible for understanding and complying with the requirements of federal statutes, regulations, and the terms and conditions of federal awards related to each of its federal programs.
- 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 federal statues, regulations, and the terms and conditions of federal awards.
- Management has identified and disclosed all of its government programs and related activities that are subject to the Uniform Guidance compliance audit.
- Management has identified and disclosed to the auditor the requirements of federal statutes, regulations, and the terms and conditions of federal awards 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 federal awards (including amendments, if any) and any other correspondence relevant to federal programs and related activities that have taken place with federal agencies or pass-through entities.
- Management has identified and disclosed to the auditor all amounts questioned and all known noncompliance with the direct and material compliance requirements of federal awards (or a statement that there was no such noncompliance).

- Management believes that the entity has complied with the direct and material compliance requirements (except for noncompliance that was disclosed to the auditor).
- Management has charged costs to federal awards in accordance with applicable cost principles.
- Management has made available all documentation related to compliance with the direct and material compliance requirements, including information related to federal program financial reports and claims for advances and reimbursements.
- Management has disclosed to the auditor any communications from federal awarding agencies and pass-through entities regarding possible noncompliance with the direct and material compliance requirements, including communications received up to the date of the auditor's report.
- Management has disclosed to the auditor the findings received and related corrective actions taken for previous audits, attestation engagements, and internal or external monitoring that directly relate to the objectives of the compliance audit, including findings received and corrective actions taken up to the date of the auditor's report.
- Management is responsible for taking corrective action on audit findings of the compliance audit and has developed a corrective action plan that meets Uniform Guidance requirements.
- 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 (1) performed a risk assessment of each subrecipient, (2) imposed specific subaward conditions, as appropriate, and (3) monitored subrecipients, as necessary to determine that they have expended subawards in compliance with federal statutes, regulations, and the terms and conditions of the subaward and have met the other pass-through entity requirements of the Uniform Guidance.
- If applicable, management has issued management decisions for audit findings that relate to federal awards it makes to subrecipients, and that such management decisions are issued within six months of the acceptance of the report by the federal audit clearinghouse. Additionally, management has followed-up and ensured that the subrecipient takes timely and appropriate action on all deficiencies detected through audits, on-site reviews, and other means relating to the federal award the pass-through entity provided.
- If applicable, management has considered the results of subrecipient audits and has made any necessary adjustments to management'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 the Uniform Guidance.
- 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.
- The reporting package does not contain protected personally identifiable information.
- 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 the nature of any subsequent events that provide additional evidence with respect to conditions that existed at the end of the reporting period that affect noncompliance during the reporting period.

- Management has disclosed all known noncompliance with direct and material compliance requirements occurring subsequent to the period covered by the auditor's report (or a statement that there were no such known instances).

- 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 and material weaknesses in internal control over compliance, have occurred subsequent to the period covered by the auditor's report.

The auditor may determine that additional representations related to the entity's compliance with the direct and material compliance requirements are necessary. If so, the auditor should request such additional representations.

Schedule of Expenditures of Federal Awards. AU-C 725.07 and Paragraph 7.17 of the GAS/SA Audit Guide identify specific representations auditors should obtain in order to provide an opinion on whether information accompanying the financial statements is fairly presented, in all material respects, in relation to the financial statements as a whole. Thus, in a single audit, the auditor should obtain the following additional representations about the schedule of expenditures of federal awards (schedule):

- Management is responsible for the preparation of the schedule.

- Management acknowledges and understands its responsibility for the presentation of the schedule in accordance with the Uniform Guidance.

- Management believes the schedule, including its form and content, is fairly presented in accordance with the Uniform Guidance.

- The methods of measurement or presentation have not changed from those used in the prior period or, if the methods of measurement or presentation have changed, the reasons for such changes.

- Management has disclosed to the auditor information about any significant assumptions or interpretations underlying the measurement or presentation of the schedule.

- If the schedule is not presented with the audited financial statements, management will make the audited financial statements readily available to the intended users of the schedule no later than the date the entity issues the schedule and the related auditor's report.

Paragraphs 7.17 and 13.17 of the GAS/SA Audit Guide further explain that two separate representation letters might be necessary—one for the audit of the financial statements and another for the audit of the schedule of expenditures of federal awards. When the audit procedures related to the SEFA are completed subsequent to the financial statement report date and the reporting on the SEFA is included in the auditor's report on the financial statements, the report would be dual-dated. That is, the reporting on the SEFA will have a date that is later than the report on the financial statements. Because GAAS requires management's representations to be made as of the date of the auditor's report, separate representation letters would be obtained for the audit of the financial statements and the audit of the SEFA.

Materiality

AU-C 580 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. AU-C 580.A22 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, using a purely quantitative discussion of materiality because it is inappropriate to rely solely on quantitative considerations when determining materiality is discouraged.

It is not believed 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 the Uniform Guidance.

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 the financial statements in accordance with accounting principles generally accepted in the United States of America.
- 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

AU-C 580.14 states that the auditor should request management to provide written representations about whether it believes the effects of uncorrected misstatements are immaterial, individually and in the aggregate, to the financial statements 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 AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, or AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*). However, while the auditor may consider the client's decision to not record the audit adjustments when identifying and assessing fraud risk, 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 is concerned with matters occurring through the date of the auditor's report, not merely through the balance sheet date. As a result, the representation letter should be dated as of the date of the auditor's report. AU-C 580.A27 clarifies that the requirement does not mean that the auditor needs to physically possess 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 without exception. The auditor will need to physically possess the signed management representation letter prior to releasing the auditor's report. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit often sufficient to preclude an unmodified opinion and may cause the auditor to disclaim an opinion or withdraw from the engagement.

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 the Uniform Guidance.

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 the GAS/SA Audit Guide, Paragraph 3.68, the auditor should obtain representations from "those members of management with overall responsibility for financial and operating matters that the auditor believes are responsible for, and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Those individuals may vary depending on the governance structure of the entity. Such

members of management may include the CEO and CFO or others in equivalent positions (such as the management of significant components)." 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).

AU-C 580.A26 explains that even when current management was not present during all periods referred to in the auditor's report, current management's responsibilities for the financial statements as a whole are not diminished and the requirement for the auditor to request from them written representations that cover all of the relevant periods still applies. While not specifically mentioned in GAAS, best practices indicate 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 willing 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 needs to resolve the problem before beginning the engagement and 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.

Scope Limitations

It is clear that management's refusal to furnish written representations is a limitation on the scope of the engagement sufficient to preclude an unmodified opinion. AU-C 580.A34 clarifies that while management's refusal to furnish requested written representations constitutes a limitation on the scope of the audit, based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion (rather than a disclaimer or withdrawal) is appropriate. Best practices indicate that situations resulting in a qualified opinion will be limited to those where only one or perhaps a few representations are refused. Paragraph 10.77 of the GAS/SA 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 should issue a qualified opinion or disclaimer of opinion.

CONSIDERING THE ACCUMULATED RESULTS OF AUDIT PROCEDURES

Reevaluating Risk Assessments and Evaluating Audit Evidence

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 noncompliance with laws and regulations that may have a 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 federal statutes, regulations, or the terms and conditions of federal awards 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, AU-C 315.32 requires the auditor to revise the risk assessment and modify

further planned audit procedures if new information is obtained or if the initial assessed risks of material misstatement at the assertion level changes during the audit. In addition, AU-C 330.27 requires the auditor to reevaluate, before the conclusion of the audit, 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 should conclude whether sufficient appropriate audit evidence was obtained to reduce to an appropriately low level the risk of material misstatement in the financial statements 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. The GAS/SA Audit Guide, Paragraph 10.53, states that before the conclusion of a compliance audit, the auditor should evaluate whether audit risk of noncompliance has been reduced to an appropriately low level and whether the nature, timing, and extent of the audit procedures need to be reconsidered. It further states that the auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce to an appropriately low level the risks of material noncompliance with compliance requirements. Paragraph 10.54 of the GAS/SA Audit Guide explains that the auditor should consider all relevant audit evidence regardless of whether it appears to corroborate or contradict the relevant assertions.

The sufficiency and appropriateness of audit evidence is a matter of the auditor's professional judgment. AU-C 330.A75 indicates 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 materially affecting the financial statements—individually and when aggregated with other misstatements.
- Effectiveness of responses by management and controls to address the risks.
- Experience gained during prior audits regarding 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 available audit evidence.
- Understanding of the entity and its environment, including internal control.

AU-C 330.29 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. Also, communication among the engagement team about information or conditions that indicate potential risks of material misstatement due to fraud should continue throughout the audit.

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.

AU-C 240.32 requires the auditor to evaluate the business rationale for significant unusual transactions to address the risk of management override of controls by considering 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. According to AU-C 240.29, the auditor should evaluate 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.

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 statements best describes both commitments and contingencies?

    a. They consist of current situations that produce an existing obligation that might establish a requirement in the future that needs to be disclosed.

    b. They are contractual requirements for future expenses.

    c. They are incomplete uncertainties or transactions that should be disclosed due to their effect on future operating results or current financial positions.

    d. They occur from past events.

2. Alexa is conducting an audit and has requested a written representation letter from the management personnel. After Alexa reviews the representation letter, she concludes that the letter is unreliable and questions management's competence, ethical values, and integrity. According to AU-C 580, what may Alexa do next?

    a. Discuss the omission with management.

    b. Disclaim an opinion.

    c. Reevaluate management's integrity.

    d. Evaluate the reliability of management's other representations.

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 statements best describes both commitments and contingencies? **(Page 4)**

   a. They consist of current situations that produce an existing obligation that might establish a requirement in the future that needs to be disclosed. [This answer is incorrect. Only 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. This does not describe commitments.]

   b. They are contractual requirements for future expenses. [This answer is incorrect. Only commitments are contractual obligations for a future expenditure. This does not describe contingencies.]

   c. They are incomplete uncertainties or transactions that should be disclosed due to their effect on future operating results or current financial positions. [This answer is correct. 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.]

   d. They occur from past events. [This answer is incorrect. Only contingencies arise from past transactions or events. This does not describe commitments.]

2. Alexa is conducting an audit and has requested a written representation letter from the management personnel. After Alexa reviews the representation letter, she concludes that the letter is unreliable and questions management's competence, ethical values, and integrity. According to AU-C 580, what may Alexa do next? **(Page 8)**

   a. Discuss the omission with management. [This answer is incorrect. AU-C 580.26 indicates that when management does not provide one or more of the written representations requested, the auditor should first discuss the matter with management. This response does not apply to Alexa's dilemma.]

   b. Disclaim an opinion. [This answer is correct. In the situation where the auditor concludes that the written representations are unreliable, the auditor should take appropriate action, including determining any effect on the auditor's report. AU-C 580.25 indicates that the auditor should disclaim an opinion on the financial statements or withdraw from the engagement if the auditor determines that sufficient doubt exists about management's integrity and the reliability of the written representations required by AU-C 580.10–.11.]

   c. Reevaluate management's integrity. [This answer is incorrect. Alexa does not need to reevaluate management's integrity at this point. AU-C 580.26 states that when management does not provide one or more of the written representations requested, the auditor should reevaluate the integrity of management.]

   d. Evaluate the reliability of management's other representations. [This answer is incorrect. AU-C 580.26 indicates that when management does not provide one or more of the written representations requested, the auditor should evaluate the implications for the reliability of management's other written or oral representations evidence generally; and take appropriate actions. Alexa has already deemed the letter unreliable.]

REVIEW OF WORKPAPERS

Introduction and Authoritative Literature

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 performing the engagement.

Authoritative pronouncements establish only broad requirements for supervision and review. AU-C 220.18–.19 requires the engagement partner to take responsibility for review of the work performed in accordance with the firm's review policies and procedures. Based on the review of audit documentation and discussion with the engagement team, on or before the date of the auditor's report, the engagement partner should be satisfied that sufficient appropriate audit evidence has been gathered to support the conclusions reached and the auditor's report to be issued.

Quality Control System

SQCS No. 8 (QC 10.35–.36) 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 engagement partner may delegate parts of the review responsibility to other members of the engagement team, in accordance with firm quality control policies. The review may include consideration of factors such as the following (QC 10.A35 and AU-C 220.A16):

- The work has been performed in accordance with professional standards and applicable regulatory and legal requirements.
- Significant findings and issues have been raised for further consideration.
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented.
- The nature, timing, and extent of work performed are appropriate and without need for revision.
- The procedures performed support the conclusions reached and is appropriately documented.
- The evidence obtained is sufficient and appropriate to support the report.
- The objectives of the procedures performed have been achieved.

The standards provide 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 and the assessed risks of material misstatement (AU-C 300.A16).
- The engagement partner needs to direct other team members to bring to his or her attention accounting and auditing issues raised during the audit that the team member believes are significant to the financial statements or auditor's report so that he or she may assess their significance (AU-C 220.22).
- The work performed by each assistant should be supervised and a suitably experienced team member should review the work of other team members. The engagement partner may delegate parts of the review responsibility to other assistants, in accordance with firm quality control policies (AU-C 220.A15).

- 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 engagement partner 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 (AU-C 220.A20).

Audit documentation assists 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 (AU-C 230.09). These requirements do not mandate any specific arrangements for engagement administration.

Audit firms need to have 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 needs to be some mechanism for dealing with and resolving differences of opinion. QC 10.46–.48 states that firms should establish policies and procedures for dealing with and resolving differences of opinion. Those policies and procedures should require that (a) conclusions reached be documented and implemented and (b) the report not be released until the difference of opinion is resolved. Additionally, such policies and procedures should enable engagement team members to document their disagreement with the conclusions reached after appropriate consultation has taken place.

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 that—

   (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. Preparing summary and evaluation schedules and drafting the financial statements, as applicable, and the audit reports.

AU-C 230.09 requires that the workpapers indicate who reviewed specific audit documentation and the date and extent 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 AU-C 230.09 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.

Government Auditing Standards establishes an additional requirement for supervisory review. Paragraph 4.15 of the Yellow Book indicates that auditors should document evidence of supervisory review of the work performed before the report release date. A GAO official has indicated he would expect to see supervisory initials on "significant" workpapers, such as summary spreadsheets 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 the summary and evaluation schedules and documentation of significant audit findings or issues, and less time and attention are given to supporting workpapers. It is often conducted after financial statements and audit reports have been drafted and is the final check on whether the audit work supports the 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 need to 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 apparently unanswered or open matters remain in the final workpapers. Once the audit has been completed, all review points and notes need to be removed from the workpapers, as they do not constitute audit evidence.

Relationship of Workpaper Review to Dating of the Auditor's Report

AU-C 700.41 requires that the date of the auditor's report be no earlier than the date that sufficient appropriate audit 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.

AU-C 220.19 requires that by the date of the audit report, the engagement partner be satisfied that sufficient appropriate evidence has been obtained to support audit conclusions and the audit report to be issued, by discussion with the engagement team and a review of audit documentation. Best practices suggest that it is implicit in this requirement that detailed and supervisory reviews need to be completed before the engagement partner's review. AU-C 220.A17 observes that the engagement partner may review all audit documentation, but need not do so. AU-C 230.09c requires documentation of who reviewed the audit work and the review's date and extent.

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. This checklist assists the reviewer in performing and documenting the review.

Sole Practitioners

Obviously, much of this discussion on the review of workpapers is not applicable to a sole practitioner with no staff. 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. QC 10.A1 notes that the review responsibilities are not relevant when there are no staff. 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, engagement quality control reviews (EQCRs) 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. 8 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 (QC 10.38). Firms may consider the nature of the engagement, unusual circumstances or risks of the engagement, and whether other laws or regulations impact EQCR requirements. SQCS No. 8 indicates that a firm should establish policies and procedures that set forth the nature, timing, and extent of a quality control review (QC 10.40).

Best practices suggest that an engagement quality control review be performed on each single audit by someone with single audit experience.

SUMMARIZATION AND EVALUATION

Near the end of the audit, auditors are required to evaluate whether the accumulated results of the auditing procedures performed provide a high level of assurance that the financial statements, 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 except that it also encompasses consideration of noncompliance. That evaluation includes consideration of misstatements and noncompliance discovered during fieldwork, including whether identified misstatements or noncompliance are indicative of possible fraud. 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, AU-C 450.11 requires the auditor to consider the effects, both individually and in the aggregate, of all uncorrected misstatements to determine whether they are material to the financial statements. In addition, AU-C 240.35 requires the auditor to consider whether identified misstatements are indicative of fraud. To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers. For a Uniform Guidance compliance audit, however, the auditor considers the effects of noncompliance in relation to each major federal program. The objective of testing for compliance in a single audit is to express an opinion on whether the organization has complied, in all material respects, with federal statues, regulations, and the terms and conditions of federal awards, noncompliance with which *could* have a direct and material effect on each major program.

For purposes of assessing compliance, AU-C 935.11 defines *material noncompliance* as ". . . a failure to follow compliance requirements or a violation of prohibitions included in the applicable compliance requirements that results in noncompliance that is quantitatively or qualitatively material, either individually or when aggregated with other noncompliance, to the affected government 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 compliance audits under the Uniform Guidance 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, the Uniform Guidance 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 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 10.12 of the GAS/SA 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." The evaluation of whether the auditee materially complied with the direct and material compliance requirements includes consideration of noncompliance that the auditor identified, regardless of whether the entity corrected the noncompliance after it was brought to management's attention. Paragraph 10.12 of the GAS/SA Audit Guide indicates that instances of noncompliance that are material to one major program may not be material to a major program of a different size or nature.

In a Uniform Guidance compliance audit, the compliance requirements that may have a direct and material effect on a major program are considered to be the applicable compliance requirements. AU-C 935.A31 lists the following factors the auditor might consider in evaluating whether the recipient materially complied with the applicable compliance requirements:

a. The frequency of noncompliance with the applicable compliance requirements identified in the audit.

b. The nature of the noncompliance with the applicable compliance requirements identified.

c. The adequacy of the entity's system for monitoring compliance with the applicable compliance requirements and the possible effect of any noncompliance on the entity.

d. Whether any identified noncompliance with the applicable compliance requirements resulted in likely questioned costs that are material to the program.

The auditor's evaluation includes consideration of noncompliance identified by the auditor that was corrected after being brought to management's attention.

Projecting Questioned Costs and Expanding Testing

Questioned Costs. 2 CFR section 200.84 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 statute, regulation, or the terms and conditions of a federal award, 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.

Effect of Questioned Costs on the Major Program Compliance Opinion. Paragraph 10.60 of the GAS/SA 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)." Likely questioned costs are developed by extrapolating from audit evidence obtained, for example, by projecting known questioned costs identified in an audit sample to the entire population from which the sample was drawn. This guidance is also included in 2 CFR section 200.516(a)(3). AU-C 935.29 takes this requirement a step further, requiring the auditor to also evaluate other material noncompliance that, by its nature, might not result in questioned costs. For example, noncompliance with a reporting requirement typically would not result in questioned costs. In situations where known questioned costs are not considered to be material but the likely questioned costs are, the auditor should consider the noncompliance to be material and report an audit finding. Alternatively, the auditor could expand the scope of the audit and apply additional audit procedures to further establish the amount of likely questioned costs.

Projecting Questioned Costs. The GAS/SA Audit Guide, Paragraph 11.116, explains that regardless of whether a sample is statistical or nonstatistical, "the auditor should evaluate the nature and cause of the noncompliance to reach an overall conclusion on compliance with a particular type of compliance requirement." Paragraph 11.118 further explains that because the auditor is required to determine and report both known questioned costs and estimate likely questioned costs, it may be necessary to project the sample results when determining the effect on the opinion on compliance and whether an audit finding has to be reported. The Uniform Guidance does not require that the auditor expand the scope of a sampling application (i.e., test additional transactions) to definitely determine the total questioned costs. Instead, the auditor is only required to consider the effect of likely questioned costs on the compliance opinion and report an audit finding when the estimate of likely questioned costs exceeds $25,000. The auditor should document the noted exceptions (i.e., the questioned costs). If the known or likely questioned cost exceeds $25,000, the auditor is required to report the finding.

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. AU-C 240.34 indicates that at or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. AU-C 240.35 further explains that if the auditor identifies a misstatement, the auditor should evaluate whether such a misstatement is indicative of fraud. If such an indication exists, the auditor should evaluate the implications of the misstatement with regard to other aspects of the audit, including the auditor's evaluation of materiality, management and employee integrity, and the reliability of management representations, recognizing that an identified instance of fraud is unlikely to be an isolated occurrence. According to AU-C 240.36, if the auditor

has reason to believe that a misstatement (whether material or not) is the result of fraud and that management (in particular, senior management) is involved, the auditor should reevaluate the assessment of the risks of material misstatement due to fraud and its resulting effect on the nature, timing, and extent of audit procedures to respond to the assessed risks. The auditor should also consider whether circumstances or conditions indicate possible collusion involving employees, management, or third parties when reconsidering the reliability of evidence previously obtained. If the auditor concludes that, or is unable to conclude whether the financial statements are materially misstated as a result of fraud, the auditor should evaluate the implications for the audit.

According to AU-C 240.A56, the evaluation of accumulated audit results may provide additional insight about the risks of material misstatement due to fraud and whether it is necessary 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 may consider it 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 awarding 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 awarding 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 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* Requirements.** Paragraph 4.06 of the Yellow Book explains that the AICPA requirements pertaining to the auditors' responsibilities for laws and regulations also apply to consideration of compliance with provisions of contracts or grant agreements. Stated another way, *Government Auditing Standards* requires auditors to design their audits to provide reasonable assurance of detecting noncompliance with the provisions of contracts or grant agreements that could have a material effect on the financial statements.

Government Auditing Standards goes beyond GAAS and establishes specific requirements related to abuse. Paragraph 4.08 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 noncompliance.

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 are required to 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. The auditor's judgments about materiality in audit planning may be different than materiality used in evaluating audit

findings because it is not possible to anticipate everything that could ultimately influence judgments about materiality when evaluating audit findings at completion of the audit. While performing the audit, the auditor may have become aware of quantitative or qualitative factors that were not initially considered but could be important to users of the financial statements. Those factors should be considered in making materiality judgments about audit findings. AU-C 935.A8 clarifies that, in a compliance audit, the auditor's judgment about matters that are material is based on consideration of the needs of users as a group, including awarding agencies. If the auditor concludes that a lower materiality level than initially determined is appropriate, the auditor should reconsider preliminary judgments about materiality and the appropriateness of the nature, timing, and extent 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 (including the nature and scope of the consultation) and the resolution of the issue should be documented in the workpapers as required by AU-C 220.25d, 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 likely there is a specialist 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. 8 (QC 10.37) indicates that a firm should establish policies and procedures designed to provide it with reasonable assurance that:

- Appropriate consultation takes place on difficult or contentious issues.
- Sufficient resources are available to enable appropriate consultation.
- The nature and scope of the consultation are documented and agreed upon by the individual seeking consultation and the individual being consulted.
- Conclusions resulting from the consultations are (a) documented, (b) understood by both the individual seeking consultation and the individual being consulted, and (c) implemented.

Documentation of Findings

AU-C 450.12 states that the auditor should prepare documentation of the following:

- The amount below which misstatements would be regarded as clearly trivial.
- All misstatements accumulated by the auditor during the audit, and whether they have been corrected by management.
- 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.

AU-C 935 makes these requirements applicable to a compliance audit.

Best practices indicate 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 has historically drafted or assisted with drafting the financial statements. Because single audits are subject to *Government Auditing Standards*, auditors have to consider the Yellow Book independence standards as well as the AICPA independence standards when determining whether their participation in drafting the financial statements and notes could impair their independence. According to ET 1.295.010.06, activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are outside the scope of attest engagements and, therefore, are nonattest services and could impair auditors' independence.

It is important to note that the Yellow Book identifies specific nonaudit services that always impair independence and that auditors are prohibited from providing to audited entities. If a nonaudit service is not specifically prohibited, the auditor is required to assess its impact on independence using the Yellow Book′s conceptual framework for independence.

Because preparing the financial statements and assisting with their preparation are not specifically identified in the Yellow Book as being prohibited, these services are considered to be nonaudit services that have to be evaluated using the conceptual framework. Furthermore, because financial statement preparation is such a critical part of the audit, it will almost always be a significant threat to independence for which safeguards should be applied and documented. A conclusion that financial statement preparation is *not* a significant threat would be very rare. There are not many effective safeguards available to eliminate this threat or reduce it to an acceptable level. Paragraph 3.18 of the Yellow Book indicates that while an auditor generally may be able to place limited reliance on safeguards that the entity has implemented, they cannot be the only safeguards applied. Best practices indicate that one possible effective safeguard may be to have Yellow Book engagements go through the firm's independent quality control review (EQCR). However, the reviewer would have to be proficient in the type of audit. Another option for entities that need assistance with drafting the financial statements may be to have a separate firm assist them with that task. Paragraph 3.09 of the Yellow Book specifically states "if no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired." Paragraph 3.25 of the Yellow Book further states that if an auditor's independence is impaired the auditor should "decline to perform a prospective audit or terminate an audit in progress."

The AICPA webinar, *2011 Yellow Book: Evaluation of Independence When Performing Nonaudit Services—A Peer Review Perspective* (presented June 12, 2013), discussed several important considerations for peer reviewers, which also have implications for audit firms. A speaker on the webinar indicated that the GAO's unofficial position is that any service the auditor does that is not in the SAS's is a nonaudit service. This would encompass services such as assisting with preparation of the financial statements, preparing cash-to-accrual conversions, preparing bank reconciliations, etc. Even if the client provides all of the information needed to prepare the financial statements and the auditor prepares them because he or she has the report writing software, the GAO's position is that the auditor is preparing the financial statements.

Other considerations covered in the webinar included determining whether the auditor had identified all threats and had evaluated them individually and in the aggregate. Among other things, peer reviewers will likely check to see whether the auditor listed financial statement preparation as a nonaudit service. They will also likely check whether the auditor prepared significant reconciliations and other workpapers that are part of the audit documentation. Indicators of potential significant threats include the following:

- Multiple nonaudit services were performed.
- The nonaudit services were significant to the subject matter of the audit.
- The auditor made significant assumptions and judgments.
- The nonaudit services involved a significant degree of subjectivity.
- The entity's books and records were in poor condition.

It is also important to note that, *before* agreeing to provide any nonaudit service (even preparing or assisting with preparing the financial statements), the auditor should determine whether providing the service would create a threat to independence, either by itself or in the aggregate with other nonaudit services. This includes determining whether the entity has designated an individual with suitable skill, knowledge, or experience (SKE) to oversee the services. Thus, before evaluating the significance of a threat, the auditor has to assess the SKE of the individual designated to oversee the nonaudit service, including preparation of the financial statements or assistance with their preparation. The GAS/SA Audit Guide, Paragraph 2.19, states:

> A critical component of the determination is consideration of management's ability to effectively oversee the nonaudit service to be performed. The auditor should determine whether the auditee has designated an individual who possesses suitable skill, knowledge, or experience, and that the individual understands the services to be performed sufficiently to oversee them. However, the individual is not required to possess the expertise to perform or reperform the services. The auditor should document consideration of management's ability to effectively oversee the nonaudit services to be performed, regardless of whether the threats to independence are determined to be significant . . . If an auditee does not have suitable skill, knowledge, or experience as it relates to the service, then independence would be impaired if the nonaudit service were performed.

To put it succinctly: "No SKE = No Independence." If the auditor is not independent, it is not necessary to do any further evaluation or assessment. Furthermore, application of safeguards cannot overcome a lack of SKE.

Similar considerations apply when the auditor assists in drafting the schedule of expenditures of federal awards. The GAS/SA Audit Guide, Paragraph 8.01, notes that the Uniform Guidance places the responsibility for preparing the schedule of expenditures of federal awards on the auditee. Best practices indicate that assisting with its preparation, similar to assisting with preparation of the financial statements, would be considered a nonaudit service that the auditor has to evaluate using the Yellow Book's conceptual framework for independence.

The organization's management and the governing body need to 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.

Management needs to also understand that the auditor's involvement in financial statement preparation may represent a significant deficiency or material weakness in internal control that should be communicated to management and those charged with governance.

DATA COLLECTION FORM

To streamline the distribution of audit reports and improve the government-wide collection and analysis of single audit results, 2 CFR section 200.512(b) 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 Audit Clearinghouse. The form provides key information about the nonfederal entity, the federal awards it administers, whether the audit was completed in accordance with the Uniform Guidance, and the audit results. It serves as the basis for developing a government-wide database on covered federal awards administered by nonfederal entities. The database of information on data collection forms is available online at the Federal Audit Clearinghouse website, **https://harvester.census.gov/facweb**. 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.

The data collection form can only be completed online and must be submitted electronically using the Federal Audit Clearinghouse's Internet Data Entry System (IDES). For periods ending in 2014 or later, audit submissions must be unencrypted and in a textsearchable PDF format. It is important to use the version of the data collection form that is specific to the fiscal year that was audited. The 2016 data collection form must be used for audits of fiscal periods beginning on or after December 26, 2014, the period for which the audit requirements in Subpart F of the Uniform Guidance are first effective. (For all audits that are performed under OMB Circular A-133, the appropriate previous

versions of the form must be used. The 2013 data collection form must be used for audits of fiscal periods ending in 2013 or 2014, and fiscal periods ending prior to December 25, 2015.) Links to the 2016 data collection form, instructions, frequently asked questions, and IDES are available on the Federal Audit Clearinghouse website at **https://harvester.census.gov/facides/InstructionsDocuments.aspx**.

Some federal agencies require additional reporting specific to that agency or program (for example, the U.S. Department of Housing and Urban Development requires certain financial and compliance reports to be made through HUD REAC). Those additional reporting requirements do not supersede or change the reporting requirements to the Federal Audit Clearinghouse.

Auditor Responsibilities

2 CFR section 200.512 requires that the auditor complete applicable sections of the data collection form and ensures that the auditor's portion of the reporting does not include any protected personally identifiable information. Part III, Information from the Schedule of Findings and Questioned Costs, of the 2016 data collection form (which is completed by the auditor) includes the following information:

Item 1—Major Program Information and Audit Findings

The columns that comprise Part III, Item 1 are a continuation on the right of the same schedule as Part II, Federal Awards, which provides information about each federal program for which federal awards were expended. (Part II is completed by the auditee.)

- Whether the program was a major program and, if so, the type of report the auditor issued on compliance for the program (i.e., unmodified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).

- The number of audit findings, if any, for the program.

Item 2—Financial Statement Information

- The type of auditor's report issued on the financial statements (i.e., unmodified, qualified, adverse, or disclaimer of opinion) and whether the financial statements were prepared in accordance with GAAP or a special purpose framework.

- If a special purpose framework is used:

  - The special purpose framework used (i.e. cash, tax, regulatory, or other basis).

  - Whether the special purpose framework used is required by state law or tribal law.

  - The type of auditor's report on the special purpose framework (i.e., unmodified, qualified, adverse, or disclaimer).

- Whether a going concern emphasis-of-matter paragraph was included in the auditor's report on the financial statements.

- Whether significant deficiencies, material weaknesses, or material noncompliance was identified.

Item 3—Federal Programs

- Whether the auditor's report includes a statement that the financial statements include departments, agencies, or other organizational units expending $750,000 or more in federal awards that have separate single audits and that are not included in this audit.

- The dollar threshold used to distinguish between Type A and Type B programs.

- Whether the nonfederal entity qualified as a low-risk auditee.
- Whether prior audit findings related to direct funding are shown in the summary schedule of prior audit findings.
- An indication, by checkmark, of any agencies that have current year or prior year audit findings related to direct funding.

Item 4—Federal Award Audit Findings

Note: Federal awarding agency prefix, CFDA three digit extension, additional award identification, and name of federal program are populated automatically from Part II, Item 1.

- The information on Part III, Item 4 directly corresponds to the number of findings indicated in Part III, Item 1, column (c). For each finding noted on Item 1, column (c), the following details are included in Item 4:
  - Audit finding reference numbers.
  - Type of compliance requirements.
  - Whether the finding was identified in the Report on Compliance for Each Major Federal Program as the basis for a modified opinion, other matter, or neither.
  - Whether the finding was identified in the Report on Internal Control over Compliance as a material weakness, significant deficiency, or neither.
  - Whether the finding is an other finding.
  - Whether there were any questioned costs related to the finding.
  - Whether the finding is a repeat audit finding from the prior year.
  - If the finding is a repeat audit finding, the audit finding reference number(s) from the prior year.

Auditor Certification

According to Paragraph 13.56 of the GAS/SA Audit Guide, the date the auditor certifies the auditor's statement indicates the completion date of the form as it relates to the auditor. The wording of the auditor's statement states that no auditing procedures were performed since the date of the audit reports. This wording releases the auditor from any subsequent event responsibility with regard to the timing of the completion of the form and the completion of the audit. The auditor's statement includes the following—

- The data elements and information included in the data collection form are limited to those prescribed by the Uniform Guidance.
- The information in Part II of the form is the responsibility of the auditee and is based on information included in the reporting package required by the Uniform Guidance.
- The information included in Part III of the form, except for Part III, Item 2(a)(iii), Item 3(d), and Items 4(a)-(d) (when there are audit findings), was transferred by the auditor from the auditor's report(s) for the period described in Part I, Items 1 and 3, and is not a substitute for such reports.
- The auditor has not performed any auditing procedures since the date of the auditor's report(s) or any additional auditing procedures in connection with completion of the form.

- A copy of the reporting package required by the Uniform Guidance, which includes the complete auditor's report(s), is required to be made available by the FAC on the FAC web site.
- It is also available from the auditee at the address identified in Part I of this form and on the FAC web site.

The data collection form includes a certification to be completed by the auditor as well as an auditee certification.

Audit Finding Reference Number Standardized Format

Part III of the data collection form requires the auditor to include a reference number for each audit finding. Data collection form submissions must identify audit findings with reference numbers that have a four digit audit year, a hyphen, and a three digit sequence number (e.g., 20X1–001, 20X1–002, etc.) Per 2 CFR section 200.516(c), the reference numbers on the data collection form must match those reported in the schedule of findings and questioned costs.

Auditee Responsibilities

2 CFR section 200.512 states the auditee is responsible for electronically submitting the data collection form and the reporting package, including the auditor's reports, and signing a certification statement. It also requires the auditee to make this information available to the public and to ensure that the auditee's part of the reporting package does not include any protected personally identifiable information (PII). Footnote 17 Paragraph 10.52 of the GAS/SA Audit Guide, explains that a senior level representative of the auditee must sign a statement that the reporting package does not include protected PII. After the data collection form has been entered and it passes all edits, an electronic image file containing the reporting package is attached. Then, the data collection form is electronically certified by both the auditee and the auditor. The auditee's and auditor's certifications complete the submission.

Due Date

2 CFR section 200.512(a) states that the reporting package must be submitted the earlier of 30 calendar days after receipt of the auditor's reports or nine months after the end of the audit period. The Uniform Guidance does not have a provision addressing whether the cognizant or oversight agencies may extend due dates. Furthermore, per 2 CFR section 200.520, in order for an entity to meet low-risk auditee criteria, the data collection form and reporting package must have been submitted by the due date for each of the two preceding audit years.

The OMB periodically grants extensions of time to file the reporting package. Previously, OMB granted an extension until October 31, 2015, for submissions due between July 22, 2015 and September 30, 2015, because a data breach in 2015 and an ongoing IT security investigation made it necessary for the federal audit clearinghouse website to be temporarily shut down. Most recently, an extension until September 19, 2016, was granted for submissions of reporting packages for audits performed under the Uniform Guidance originally due prior to September 19, 2016. This extension was only for the actual submission of the reporting package to the FAC. The audit and report issuance deadlines under the Uniform Guidance were not affected by this extension for the reporting package. Auditors and auditees should monitor due dates closely.

Public Availability of Single Audit Reports

2 CFR section 200.512 indicates that, except for Indian tribes electing otherwise, the auditee must make the audit reporting package available for public inspection and has to authorize the FAC to make the reporting package and data collection form publicly available on its website. In addition, according to 2 CFR section 200.512(g), the FAC is responsible for making the reporting package available to the public. Associated with these requirements, the auditee and auditor must ensure the reporting package does not contain any protected personally identifiable information (such as names, social security numbers, etc.). The Single Audit Database Information can be accessed at: **http://harvester.census.gov/fac/dissem/accessoptions.html**.

Data Collection Form for Uniform Guidance Audits

The FAC has revised the data collection form for audits of fiscal years beginning on or after December 26, 2014, in order to accommodate Uniform Guidance audits. The FAC indicated they had extended the due date for certain

data collection form and Uniform Guidance reporting package submissions until September 19, 2016. The following is a listing of some of the revisions to the data collection form:

- Removed fax numbers from Part I.
- Part II will be completed by the auditee and list all federal awards expended during the fiscal year.
- Additional CFDA information:
  - CFDA three digit extension. If unknown, enter a U followed by a two-digit number (e.g. U01, U02, etc.).
  - CFDA notes field will allow for optional inclusion of contract number or other identifying information.
- Recovery Act column removed.
- Loan/loan guarantee information will be collected.
- Loan balance amounts will be collected.
- New question as to whether amounts were passed through to a subrecipient, and if so, the identifying number and the amount.
- Additional cluster information:
  - Indication of whether a program is part of a cluster, and if so, the type of cluster (e.g., R&D, SFA, other, state created).
  - Total amount expended for clusters.
- Additional questions if the financial statements were not prepared in accordance with GAAP indicating the special purpose framework and whether the special purpose framework was required by state or tribal law.
- Additional audit finding information, including indication of whether an audit finding is a repeat finding, and if so, the prior year audit finding reference number.
- Certifications for both the auditee and auditor are revised. The auditee certification includes language about ensuring that the data collection form and reporting package do not include protected personally identifiable information or business identifiable information. Also, additional certifications required by the Uniform Guidance are included, including authorizing the FAC to make the reporting package publicly available on a website.

Submission of Data Collection Form and Single Audit Reporting Package

The data collection form is 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, the 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 data collection form and submit the single audit reporting package, auditees and auditors should access the Federal Audit Clearinghouse's website at **https://harvester.census.gov/facweb/default.aspx/formoptions.html** and select "Submit an Audit." The IDES can also be accessed directly at **https://harvester.census.gov/facides/.** The IDES requires each user to obtain their own, unique user name and password. Each user can register through the Federal Audit Clearinghouse website at **https://harvester.census.gov/facides/.**

The Federal Audit Clearinghouse provides detailed instructions for the entire submission process in the "Internet Data Entry System (IDES) User Manual,which can be downloaded from the IDES website at

https://harvester.census.gov/facides/files/IDES%20Instructions%20UG%202016.pdf. Auditors and the responsible officials from the auditee are encouraged to review the instructions thoroughly, well in advance of the deadline, before beginning the submission process.

Searchable PDFs

The OMB has specific electronic file submission requirements. As of January 2, 2015, all reporting package uploads, including auditor's reports, must be text searchable (at least 85%), unlocked, and unencrypted PDF files. Detailed guidance on creating a compliant PDF single audit report is provided on the Federal Audit Clearinghouse website at **https://harvester.census.gov/facweb/files/create_pdf_instructions.pdf**. The website also has a "PDF Validator" available on the home page that will test the PDF file for compliance with the requirements.

Resubmission

One of the enhancements made in IDES by the Federal Audit Clearinghouse 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 and select the "Revise (Submitted Audits)" option. Detailed instructions for revised submissions are included in the Federal Audit Clearinghouse's document, "Internet Data Entry System (IDES) User Manual. " The revised submission must be certified by the auditee and signed by the auditor. No paper copies are required to be filed with the Federal Audit Clearinghouse.

In other situations where reporting packages are revised, the authors recommend that the auditee or auditor contact the Federal Audit Clearinghouse processing center at (866) 306-8779.

Avoiding Reporting Problems

Mandatory online submission process and the edit checks that have been built into the IDES have eliminated many of the submission problems previously reported by the Clearinghouse. While the enhancements in the IDES streamline the submission process, best practices indicate that it is 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 Developments,* 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.

SELF-STUDY QUIZ

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

3. Wanda is performing a detailed review of audit work of ABC, a non-profit organization. Her 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. Ensure that each workpaper is complete and properly titled and dated.

    b. Ensure that the information on a workpaper for a financial statement component that is relevant to another element has been properly considered and cross-referenced.

    c. Ensure that any important issues have been sufficiently addressed and documented.

    d. Ensure that any unusual matters have been incorporated in the management representation letter.

4. Rose is performing an audit of Magnolia, a local government. Which of the following task should Rose perform when projecting questioned costs and expanding testing?

    a. Rose should project the amount of known questioned costs identified in the sample with the items in the major program from which the sample was selected.

    b. Rose should project questioned costs only if the sample used is statistical.

    c. Rose should expand sampling application scope to determine a more definite total questioned costs.

    d. Rose should consider the effect of likely questioned costs on the compliance opinion and report an audit finding when the estimate of questioned costs exceeds $2,500.

5. Which of the following is a true statement concerning the Yellow Book's requirements for an auditor's responsibility in drafting the financial statements in a single audit?

    a. The auditor is required to evaluate its effect on independence using the Yellow Book's conceptual framework for independence if a nonaudit service is not specifically prohibited.

    b. Preparing financial statements are not considered to be nonaudit services and are not evaluated using the Yellow Book's conceptual framework.

    c. The safeguards that the entity has in place should be effective enough and are the only safeguards an auditor needs to rely on.

6. Lawrence is in the process of completing the data collection form while concluding his audit of Rain.org. Which of the following tasks does Lawrence perform **incorrectly** when completing the data collection form?

    a. He acknowledges that data entered in Part III of the report (with a few exclusions) is based on information in the auditor's report.

    b. He adds the type of auditor's report issued on the statements.

    c. He completes the data collection form online, prints the form, and mails it.

    d. He states that he has not performed any additional procedures since the date of the audit reports.

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.)**

3. Wanda is performing a detailed review of audit work of ABC, a non-profit organization. Her 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 20)**

   a. **Ensure that each workpaper is complete and properly titled and dated. [This answer is correct. For each financial statement component and for each financial program, Wanda will review the supporting schedules to ensure that 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. This is just one of the steps that Wanda will perform when reviewing the supporting schedules.]**

   b. Ensure that the information on a workpaper for a financial statement component that is relevant to another element has been properly considered and cross-referenced. [This answer is incorrect. For the general section of the file and the workpapers as a whole (including the permanent file), the auditor should ensure 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. Ensure that any important issues have been sufficiently addressed and documented. [This answer is incorrect. For the general section of the file and the workpapers as a whole (including the permanent file), the auditor should ensure that any significant audit findings or issues (including discussions with management and others) have been adequately addressed and documented.]

   d. Ensure that any unusual matters have been incorporated in the management representation letter. [This answer is incorrect. For the general section of the file and the workpapers as a whole (including the permanent file), the auditor should ensure that any unusual matters have been included in the management representation letter.]

4. Rose is performing an audit of Magnolia, a local government. Which of the following task should Rose perform when projecting questioned costs and expanding testing? **(Page 24)**

   a. **Rose should project the amount of known questioned costs identified in the sample with the items in the major program from which the sample was selected. [This answer is correct. Paragraph 10.60 of the GAS/SA 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)." To develop likely questioned costs, Rose will extrapolate from audit evidence obtained.]**

   b. Rose should project questioned costs only if the sample used is statistical. [This answer is incorrect. The GAS/SA Audit Guide, Paragraph 11.116, explains that regardless of whether a sample is statistical or not statistical, "the auditor should evaluate the nature and cause of the noncompliance to reach an overall conclusion on compliance with a particular type of compliance requirement."]

   c. Rose should expand sampling application scope to determine a more definite total questioned costs. [This answer is incorrect. The Uniform Guidance does not require that the auditor expand the scope of a sampling application (i.e., test additional transactions) to definitely determine the total questioned costs.]

   d. Rose should consider the effect of likely questioned costs on the compliance opinion and report an audit finding when the estimate of questioned costs exceeds $2,500. [This answer is incorrect. The auditor is required to consider the effect of likely questioned costs on the compliance opinion and report an audit finding when the estimate of likely questioned costs exceeds $25,000.]

5. Which of the following is a true statement concerning the Yellow Book's requirements for an auditor's responsibility in drafting the financial statements in a single audit? **(Page 27)**

   a. The auditor is required to evaluate its effect on independence using the Yellow Book's conceptual framework for independence if a nonaudit service is not specifically prohibited. [This answer is correct. It is important to note that the Yellow Book identifies specific nonaudit services that always impair independence and that auditors are prohibited from providing to audited entities. If a nonaudit service is not specifically prohibited, the auditor is required to assess its impact on independence using the Yellow Book is conceptual framework for independence.]

   b. Preparing financial statements are not considered to be nonaudit services and are not evaluated using the Yellow Book's conceptual framework. [This answer is incorrect. Because preparing the financial statements and assisting with their preparation are not specifically identified in the Yellow Book as being prohibited, these services are considered to be nonaudit services that have to be evaluated using the conceptual framework. Furthermore, because financial statement preparation is such a critical part of the audit, it will almost always be a significant threat to independence for which safeguards should be applied and documented.]

   c. The safeguards that the entity has in place should be effective enough and are the only safeguards an auditor needs to rely on. [This answer is incorrect. There are not many effective safeguards available to eliminate this threat or reduce it to an acceptable level. Paragraph 3.18 of the Yellow Book indicates that while an auditor generally may be able to place limited reliance on safeguards that the entity has implemented, they cannot be the only safeguards applied.]

6. Lawrence is in the process of completing the data collection form while concluding his audit of Rain.org. Which of the following tasks does Lawrence perform **incorrectly** when completing the data collection form? **(Page 28)**

   a. He acknowledges that data entered in Part III of the report is based on information in the auditor's report. [This answer is incorrect. The auditor's statement should include that the information included in Part III of the form, except for Part III, Item 2(a)(iii), Item 3(d), and Items 4(a)-(d) (when there are audit findings), was transferred by the auditor from the auditor's report(s) for the period described in Part I, Items 1 and 3, and is not a substitute for such reports. Therefore, Lawrence's acknowledgement is correct.]

   b. He adds the type of auditor's report issued on the statements. [This answer is incorrect. 2 CFR section 200.512 requires that the auditor prepare applicable sections of the form. One section of the form includes the type of auditor's report issued on the financial statements.]

   c. He completes the data collection form online, prints the form, and mails it. [This answer is correct. Lawrence performs this task incorrectly. The data collection form can only be completed online and submitted electronically using the Federal Audit Clearinghouse's Internet Data Entry System (IDES).]

   d. He states that he has not performed any additional procedures since the date of the audit reports. [This answer is incorrect. The wording of the auditor's statement should indicate that no additional procedures were performed since the date of the audit reports or any additional auditing procedures in connection with completion of the form. This wording releases the auditor from any subsequent event responsibility with regard to the timing of the completion of the form and the completion of the audit.]

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 awarding 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 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 3.69 of the GAS/SA 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

As mentioned earlier, 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 awarding agency 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.

It is important to note that some awarding 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 discusses all matters he or she considers significant. For example, the auditor would 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 needs to ensure that the following GAAS communication requirements (as applicable) have been met:

- AU-C 240, *Consideration of Fraud in a Financial Statement Audit*.
- AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.
- AU-C 260, *The Auditor's Communication with Those Charged with Governance*.
- AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.
- AU-C 935, *Compliance Audits*.

PPC's Guide to Audits of Local Governments and *PPC's Guide to Audits of Nonprofit Organizations* include detailed discussions about these GAAS requirements.

In addition to the requirements of the standards listed earlier, the 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

AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, establishes requirements for auditors to communicate certain control deficiencies they have identified during the audit. AU-C 265.11 states that the auditor should communicate significant deficiencies and material weaknesses identified during the audit in writing to *those charged with governance*. In addition, AU-C 265.12 states that the auditor also should communicate the following *to management*:

- In writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.

- In writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

Making such communications in writing reflects the importance of these matters and assists those charged with governance in fulfilling their oversight responsibilities.

To determine which control deficiencies to report, the auditor first identifies control deficiencies, and then evaluates them to determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses. The Yellow Book provides additional guidance about evaluating internal control related matters.

Evaluating Control Deficiencies in a Single Audit. In an audit of compliance, the significance of a control deficiency depends on the potential for noncompliance. The GAS/SA Audit Guide, Paragraph 9.52, explains that the evaluation of deficiencies in internal control over compliance includes the magnitude of potential noncompliance that could result from a control deficiency or deficiencies.

Communication With Those Charged With Governance

AU-C 260, *The Auditor's Communication with Those Charged with Governance*, requires the auditor to communicate with those charged with governance in relation to a GAAS financial statement audit. Most governmental units and nonprofit organizations will have either an audit committee or group of individuals formally designated with oversight of financial reporting. The auditor should evaluate whether communication with a subgroup of those charged with governance adequately meets the responsibility to communicate with those charged with governance.

One of the objectives stated in AU-C 260.05 is to promote effective two-way communication between the auditor and those charged with governance. Effective two-way communication assists both the auditor and those charged with governance to understand matters related to the audit and develop a constructive working relationship. It also enables those charged with governance to fulfill their responsibility to oversee the financial reporting process. Further, the auditor may be able to obtain important information from those charged with governance that is relevant to understanding the client and its environment, identifying sources of audit evidence, and obtaining information about specific events and transactions.

AU-C 260.05 identifies the types of matters to be communicated by the auditor to those charged with governance. It indicates that the auditor is to (1) clearly communicate his or her responsibilities regarding the audit, (2) provide an overview of the planned scope and timing of the engagement, and (3) provide timely observations that are significant and relevant to the responsibility of overseeing the financial reporting process.

AU-C 935.37 clarifies that in a compliance audit, the auditor's communication with those charged with governance should address:

- The auditor's responsibilities under GAAS, *Government Auditing Standards*, and the governmental audit requirement (i.e., the Uniform Guidance).
- An overview of the planned scope and timing of the compliance audit.
- Significant findings from the compliance audit.

Documentation of the Exit Conference

Following the exit conference, the auditor needs to document details of the conference in the audit workpapers. The GAS/SA Audit Guide, Paragraph 3.70, explains that the auditor might consider documenting the names of the auditors who conducted the exit conference, the names and titles of individuals with whom exit conferences were held, details of matters discussed in the conference, and comments made by officials of the organization.

WORKPAPER FINALIZATION, ACCESS, AND RETENTION

After the auditor issues the reports 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.

Assembling, Completing, and Making Changes to Audit Documentation

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.

These dates are also discussed in Lesson 2.

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. According to AU-C 700.41, 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.

This means that the auditor's report should 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 it is responsible for the financial statements (ordinarily in the management representation letter).

According to AICPA Technical Q&A, *The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report* (Q&A 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 needs to 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. AU-C 230.15

requires the auditor to document the report release date in the workpapers. In most cases, the report release date will be close to the date of the auditor's report. If there are significant delays in releasing the report, the auditor needs to consider whether to apply the guidance listed earlier on subsequent events and in Lesson 2 on dating the auditor's report. Best practices indicate that a delay in releasing the reports of more than two weeks after the report date ought to result in extending the subsequent events review to the later date and redating the reports.

Documentation Completion Date. SQCS No. 8 (QC 10.49) specifies that firms "should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been released." Those policies and procedures need to 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. Professional standards require workpapers to be completed on a timely basis (AU-C 230.07). In addition, the final assembly and completion of the audit file should occur within 60 days of the report release date. AU-C 230.06 refers to this date as the *documentation completion date*. After this date, the auditor should 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 system of quality control. In addition, the auditor needs to consider whether there are regulatory or state requirements that require a shorter documentation completion period.

AU-C 230.A26 indicates that at any time prior to the documentation completion date, the auditor is permitted to make changes to the workpapers that are administrative in nature, such as 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 changes to the workpapers after the date of the auditor's report and prior to the documentation completion date constitute those that are part of the "wrap-up" or workpaper filing process. The auditor would 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, some auditors have interpreted the requirement to mean that single audit documentation has to be assembled within 60 days of delivery of the Uniform Guidance report.

Retention of Audit Documentation

Auditors should establish policies and procedures regarding the retention 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. SQCS No. 8 (QC 10.51 and QC 10.A60) and AU-C 230.17 specifically indicate that this period should not be shorter than five years from the report release date. In addition, the procedures adopted need to enable the auditor to access electronic workpapers throughout the retention period. The Yellow Book, at Paragraph 3.92, states that auditors establish "policies and procedures for the safe custody and retention of audit documentation for a time sufficient to satisfy legal, regulatory, and administrative requirements. . ." The Yellow Book further states that auditors should establish information systems controls related to accessing and updating audit documentation that is stored electronically. 2 CFR section 200.517(a) states that the

auditor must maintain the audit documentation for a longer period if the auditor is notified in writing by the cognizant or oversight agency for audit, cognizant agency for indirect costs, 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 audit documentation or reports are destroyed. The auditor also needs to be aware that various states have enacted or are considering legislation that addresses the retention of audit documentation and may require a longer retention period.

The auditor must make audit documentation available upon request to GAO, the cognizant or oversight agency for audit or its designee, cognizant agency for indirect cost, or a federal agency upon completion of the audit.

SUBSEQUENT DISCOVERY OF MATTERS AFTER DATE OF REPORT

Introduction and Authoritative Literature

Subsequent to the date of the auditor's report, the auditor may become aware of facts that existed on that date that might have caused him to believe information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had he then been aware of them. In such circumstances, the auditor should consider the guidance in AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, in determining an appropriate course of action. Subsequent to the date of the auditor's report, the auditor may also conclude that certain necessary auditing procedures were omitted from the audit, but there is no indication that the financial statements are materially misstated. AU-C 585, *Consideration of Omitted Procedures After the Report Date*, provides guidance in that situation. AU-C 935 makes these requirements applicable to a compliance audit. Reissuance of compliance reports is discussed in lesson 2.

Subsequent Discovery of Facts Existing at the Date of the Report

AU-C 560 contains separate requirements for situations where facts are discovered before the report release date and those situations where facts are discovered after the report release date. However, when facts are discovered after the report is issued, the auditor is generally required to do the following:

- Discuss the matter with management and, when appropriate, those charged with governance.
- Determine whether the financial statements need revision and, if so, inquire how management intends to address the matter in the financial statements.
- If management revises the financial statements, perform audit procedures necessary in the circumstances on the revision and either—
    - Date the auditor's report as of a later date, extend the subsequent events audit procedures to the new date of the auditor's report, and request written representations from management as of the new date, or
    - Dual date the auditor's report for the revision and request written representations as of the additional date about whether (i) any information has come to management's attention that would cause them to believe that any of their previous representations should be modified and (ii) any other subsequent events have occurred that would require adjustment to, or disclosure in, the financial statements.
- If the audited financial statements were made available to third parties before the revision, assess whether the steps taken by management are timely and appropriate to ensure that anyone in receipt of those financial statements is informed of the situation, including that the audited financial statements should not be relied upon.
- If the auditor's opinion on the revised financial statements differs from the opinion previously expressed, determine that the appropriate disclosures are made.
- If management does not revise the financial statements in circumstances when they need to be revised—
    - If the audited financial statements were not made available to third parties, notify management and those charged with governance not to make the audited financial statements available to third parties

before the necessary revisions have been made and a new auditor's report on the revised financial statements has been provided.

- If the audited financial statements were made available to third parties, assess whether the steps taken by management are timely and appropriate to ensure that anyone in receipt of those financial statements is informed of the situation, including that the audited financial statements should not be relied upon.

- If management does not take the necessary steps to ensure that anyone in receipt of the audited financial statements before revision is informed of the situation, notify management and those charged with governance that the auditor will seek to prevent future reliance on the auditor's report. Seek to prevent future reliance on the auditor's report if management or those charged with governance still do not take the necessary steps.

According to AU-C 560.A18, the guidance is applicable even if the auditor has withdrawn or been discharged.

Consideration of Omitted Procedures

According to AU-C 585.06, when the auditor determines that certain necessary auditing procedures were omitted, the auditor should assess the importance of the omitted procedures on his ability to support his previous opinions and reports. Review of the workpapers, discussions with others assigned to the engagement, and reevaluation of the overall audit scope may be helpful in making the assessment. The results of subsequent audits also may be considered.

If the auditor concludes that he is unable to support his previous opinions and reports, and there are persons currently relying on, or likely to rely on, his report, he should promptly apply the omitted procedures or alternative procedures that would support his opinion. After applying the procedures, if the auditor becomes aware of facts existing at the date of an report that would have affected the report had he then been aware of them, he should follow the guidance discussed later in this section. If the auditor is unable to apply the omitted or alternative procedures, he may decide to consult with an attorney to determine an appropriate course of action. If performing the omitted procedures necessitates changing workpapers that have previously been finalized, auditors should document when and by whom the change was made and reviewed; the reasons for the change; and the procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report.

Because of the potential legal implications of the situations discussed beginning earlier in this section, auditors may decide to consult their attorneys any time the circumstances described in this section are encountered.

SELF-STUDY QUIZ

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

7. While concluding her audit of Summerland, Sophia holds an exit conference with key members of management. Which of the following statements best describes the requirements for this meeting?

    a. Sophia may be required to provide a written report on the exit conference.

    b. Sophia is required to invite a representative from the oversight agency for audit to attend the exit conference.

    c. During the exit conference, Sophia only discusses matters that pertain to any deficiencies in the internal control.

8. Which of the following is considered the audit report release date?

    a. The date the client is allowed to use the auditor's reports.

    b. The date the auditor obtains enough appropriate evidence to support his opinions.

    c. The date the final engagement files are assembled.

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.)**

7. While concluding her audit of Summerland, Sophia holds an exit conference with key members of management. Which of the following statements best describes the requirements for this meeting? **(Page 38)**

    a. Sophia may be required to provide a written report on the exit conference. [This answer is correct. Some awarding 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.]

    b. Sophia is required to invite a representative from the oversight agency for audit to 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. This can be in the best interest of both the auditor and the organization.]

    c. During the exit conference, Sophia only discusses matters that pertain to any deficiencies in the internal control. [This answer is incorrect. The auditor discusses all matters he or she considers significant. For example, the auditor would 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.]

8. Which of the following is considered the audit report release date? **(Page 40)**

    a. The date the client is allowed 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 obtains enough appropriate evidence to support his opinions. [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 the final engagement files are assembled. [This answer is incorrect. SQCS No. 8 (QC 10.49) specifies that firms "should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been released." This is considered the documentation completion date.]

Lesson 2: Reporting under the Single Audit

INTRODUCTION

Single Audit Reports

This lesson discusses the various auditor's 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 are the dating of auditor's reports, report due dates, report distribution, combined reports, Yellow Book reports, Uniform Guidance reports, summary schedule of prior audit findings, schedule of findings and questioned costs, and other related reporting matters.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize how to address, date, and submit an auditor's report, and identify the various audit reports that are unique to Uniform Guidance compliance audits.
- Identify the requirements for reporting on internal control over financial reporting and on compliance as required by Government Auditing Standards, and how to prepare and report on the schedule of expenditures of federal awards.
- Recognize compliance reporting requirements applicable to each major program and internal control as required by Uniform Guidance, and how to prepare a summary schedule of prior audit findings.
- Identify the GAAS requirements for reporting fraud, noncompliance, and abuse, and the auditor's reporting and communications responsibilities under Government Auditing Standards and Uniform Guidance with respect to control deficiencies.
- Recognize what is included in the schedule of findings and questioned costs as well as rules for other reporting matters.

Organization of This Lesson

This lesson covers the following types of reporting:

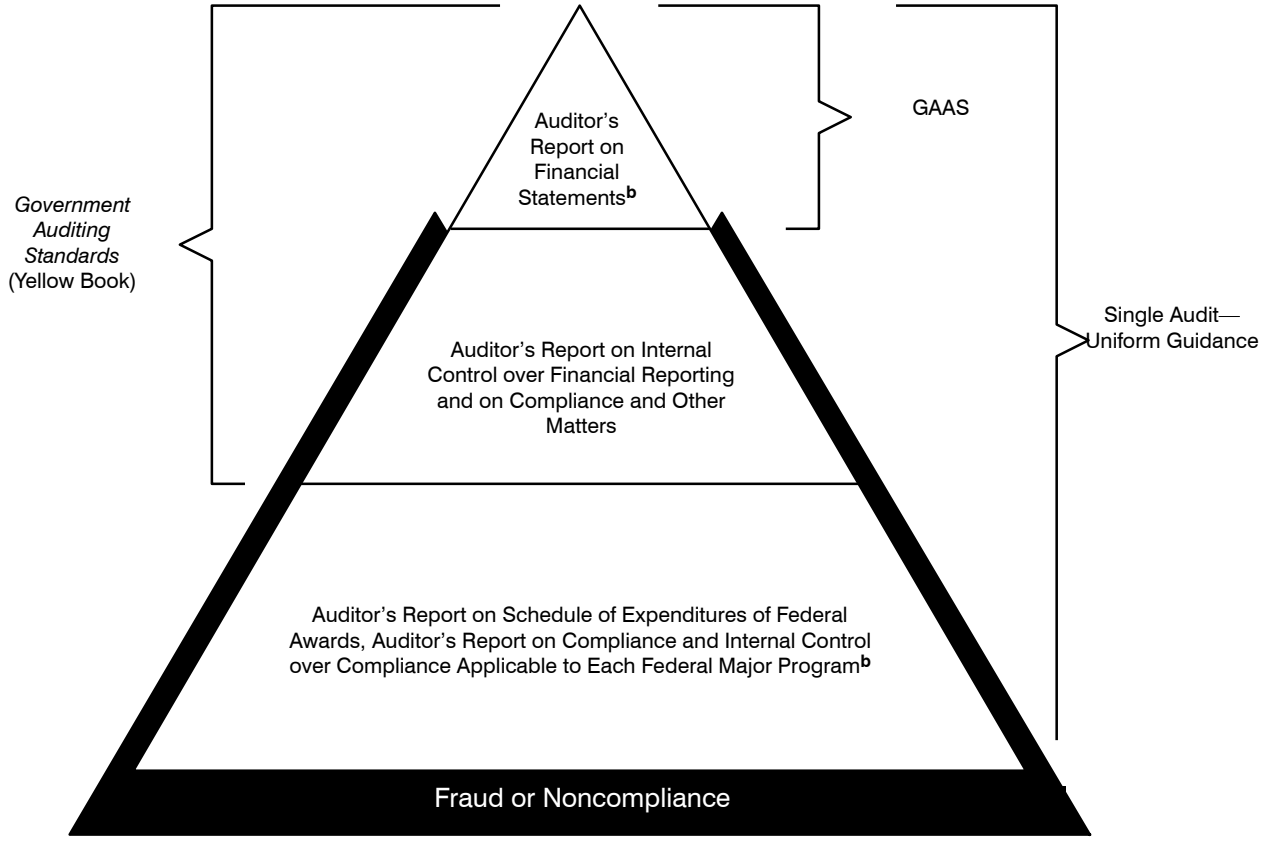
- Reporting on financial statements in a single audit.
- Reporting on internal control over financial reporting and on compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards*; i.e., the Yellow Book.
- Reporting on the schedule of expenditures of federal awards.
- Reporting on compliance with requirements applicable to each major program and on internal control over compliance in accordance with the Uniform Guidance.

Auditor's Reports

Exhibit 2-1 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 2-2 presents the same information in a matrix format.

Exhibit 2-1

Reports Required by GAAS, *Government Auditing Standards*, and Single Audits[a]



Notes:

[a] The AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide), includes illustrated auditor's reports that comply with single audit guidance.

[b] GAS/SA Audit Guide, Paragraph 13.11, explains that reporting using an other matter paragraph is applicable when the SEFA is reported on in the auditor's report on the financial statements. Otherwise, the reporting on the SEFA may be included in the Uniform Guidance report on compliance and on internal control over compliance, or in a separate report. When the SEFA is not presented with the financial statements, the auditor should report on the SEFA in either the report on compliance and on internal control over compliance or in a separate report. The report examples in Chapter 13 of the GAS/SA Audit Guide illustrate both inclusion of the report on the SEFA in the report on the financial statements and inclusion of it in the Uniform Guidance report.

* * *

Exhibit 2-2

Required Auditor's Reports[a, b]

	GAAS FINANCIAL AUDIT	*GOVERNMENT AUDITING STANDARDS*[c]	SINGLE AUDIT[c]
FINANCIAL STATEMENTS	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 compliance
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 federal statutes, regulations, and terms and conditions of federal awards—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 Single Audits* (GAS/SA Audit Guide), includes illustrated auditor's reports that comply with single audit guidance.

[b] The auditor should consider all appropriate notes when drafting the reports.

[c] The illustrative reports in the GAS/SA Audit Guide combine (1) the reporting on internal control over financial reporting and on compliance and other matters required by *Government Auditing Standards* into a single report (Examples 4-3–4-9), (2) the reporting on major program compliance and internal control over compliance into a single report (Examples 13-1–13-6), and (3) the reporting on the schedule of expenditures of federal awards both with the report on the financial statements (Examples 4-1 and 4-2) and the report on compliance and internal control over compliance (Examples 13-1–13-6). If the schedule is not presented with the financial statements, the auditor should report on it in either the report on compliance and internal control over compliance or in a separate report. Example 13-8 illustrates a report on the SEFA under AU-C 805, *Special Considerations—Audits of Single Financial Statement and Specific Elements, Accounts, or Items of a Financial Statement*.

* * *

Authoritative Literature

The authoritative pronouncements discussed in this lesson that establish requirements or provide guidance that most directly affect the auditor's reporting and communication requirements are as follows:

- AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.
- AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.
- AU-C 700, *Forming an Opinion and Reporting on Financial Statements*.
- AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*.
- AU-C 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*.
- AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*.
- AU-C 800, *Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*.
- AU-C 905, *Alert That Restricts the Use of the Auditor's Written Communication*.
- AU-C 935, *Compliance Audits*.
- *Government Auditing Standards, 2011 Revision* (Yellow Book) (a link is included in *PPC's Government Documents Library* at Gov. Doc. No. 2).
- Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200 *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (a link is included in *PPC's Government Documents Library* at Gov. Doc. No. 15).
- AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide).

GAS/SA Audit Guide. The GAS/SA Audit Guide provides reporting guidance and illustrative examples of auditor's reports issued in accordance with *Government Auditing Standards* (the Yellow Book) and the Uniform Guidance. Conforming changes made in the GAS/SA 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. This course has been updated for the April 2017 edition of the GAS/SA Audit Guide.

Single Audit Report Examples

The single audit report illustrations in this lesson are based on authoritative literature and the GAS/SA Audit Guide. The GAS/SA Audit Guide, at Paragraph 13.06, recommends issuing the following three reports:

- A report on the financial statements and on the schedule of expenditures of federal awards (SEFA).
- A Yellow Book report on internal control over financial reporting and on compliance and other matters.
- A single audit report on compliance with requirements that could have a direct and material effect on each major program and on internal control over compliance.

In addition, 2 CFR section 200.515(d) requires the auditor to prepare a schedule of findings and questioned costs.

ADDRESSING AND DATING AUDITORS' REPORTS

Addressing the Report

The reports should be addressed to the individual or group who retained the auditor. For a governmental entity, it is usually the legislative authority of the governmental unit; e.g., the city council, school board, or county commission. For a nonprofit organization, the report is usually addressed to the governing board; for example, the board of directors or trustees. Some auditors refer 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] ").

Dating the Reports

Auditor's Report on Financial Statements. AU-C 700.41, *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 on the financial statements. This will usually be a date later than the completion of fieldwork because it encompasses review of the audit documentation; preparation of financial statements and disclosures, and single audit reports; and obtaining management's assertion that they have taken responsibility for the financial statements. This means that the auditor needs to coordinate the audit report date and management representation letter date.

Management's representation letter should be dated as of the date of the auditor's report on the financial statements. AU-C 580.A27 indicates that this 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 without exception. 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 often sufficient to preclude an unmodified opinion.

Dual Dating of Auditor's Report. 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. The same two options (that is, dating as of the later date or dual dating) are available when the auditor becomes aware of a matter after the date of the auditor's report but before the report release date that requires revision of the financial statements and management revises them. 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 and the auditor might determine that it is appropriate to obtain additional representations relating to the subsequent event. Audit procedures related to subsequent events for a single audit are discussed in Lesson 1.

Auditor's Report on Schedule of Expenditures of Federal Awards. According to AU-C 725.12, the date of the auditor's report on the SEFA should not be earlier than the date the auditor completed the procedures required in AU-C 725.07. Paragraph 13.16 of the GAS/SA Audit Guide clarifies that this means the date of the auditor's report on the SEFA would be either the same date as that of the report on the financial statements or a later date. In no case would the date of the in-relation-to opinion on the SEFA be earlier than the date of the report on the financial statements.

The GAS/SA Audit Guide recommends combining the reporting on the SEFA with the report on the financial statements when the SEFA is presented with the financial statements. However, the auditor has the option of issuing a separate report on the SEFA. Paragraph 13.11 of the GAS/SA Audit Guide explains that when the SEFA is presented with the financial statements, the auditor should report on the SEFA either in an other-matter paragraph in the report on the financial statements, in the Uniform Guidance report on compliance and internal control over compliance, or in a separate report. When the SEFA is not presented with the financial statements, the auditor should report on the SEFA in either the report on compliance and on internal control over compliance or in a separate report.

Schedule of Expenditures of Federal Awards Presented with the Financial Statements. Paragraph 13.17 of the GAS/SA Audit Guide states that when the reporting on the SEFA is included in the report on the financial statements, the date of the report on the SEFA depends on when the auditor has completed the procedures required for the SEFA. When those required procedures are performed at the same time as the financial statement audit procedures, the date of the report on the SEFA and the date of the report on the financial statements will be the same. However, when the procedures related to the SEFA are completed subsequent to the financial statement report date, the reporting on the schedule will carry a later date than the financial statement report, thus resulting in a dual dated report.

Schedule of Expenditures of Federal Awards Presented with the Report on Compliance and Internal Control over Compliance. As noted previously, there may be circumstances in which the auditor includes the in-relation-to opinion on the SEFA in the Uniform Guidance report on compliance and internal control over compliance. Paragraph 13.19 of the GAS/SA Audit Guide explains that, in that situation, the date of the report on the SEFA depends on the date the underlying audit procedures are completed. If using the same date is not possible because the procedures to satisfy the Uniform Guidance requirements are not completed as of the date the procedures related to the SEFA are completed, the auditor has two options:

a. Dual date the Uniform Guidance report on compliance and on internal control over compliance. The date related to the portion of the report pertaining to the in relation-to-opinion on the SEFA would be the date when the audit procedures for the SEFA are completed. The date for the rest of the report would be the date when the audit procedures performed to satisfy the Uniform Guidance requirements are completed.

b. Issue a separate report on the SEFA. This report should be dated as of the date the auditor completed the procedures required under AU-C 725.07.

Other Reporting Considerations. 2 CFR section 200.514(a) requires a financial statement audit in accordance with *Government Auditing Standards*. Thus, 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 would need to be performed in accordance with *Government Auditing Standards* in order to comply with the Uniform Guidance requirements. This is the case even if the auditee would not be subject to a Yellow Book audit except for the requirement to have a compliance audit in accordance with the Uniform Guidance.

The auditor may be engaged to issue a stand-alone opinion on the schedule of expenditures of federal awards either as part of the report issued to meet the requirements of the Uniform Guidance or separately. However, the auditor needs to exercise caution if engaged to perform only the compliance audit. Paragraph 13.20 of the GAS/SA Audit Guide explains that when the auditor is engaged to perform only the Uniform Guidance compliance audit and not the financial statement audit, the auditor is precluded from issuing an in-relation-to opinion on the SEFA. Instead, the auditor may be engaged to provide a stand-alone opinion under AU-C 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*. When this occurs, the auditee may consider engaging the auditor to issue an opinion on the SEFA.

Yellow Book Report. The GAS/SA Guide, at Paragraph 4.53, recommends combining into one report the *Government Auditing Standards* reports on internal control over financial reporting and on compliance and other matters. Footnote 34 to Paragraph 4.54v. further explains that because that reporting relates to the audit of the financial statements and is based on the GAAS audit procedures performed, it should be dated the same as the date of the auditor's report on the financial statements.

Internal Control and Compliance Report on Federal Programs. As discussed in Paragraph 13.28 of the GAS/SA Audit Guide, generally the report on compliance and internal control over compliance related to major federal programs required by the Uniform Guidance is dated the same as the report on the financial statements. However, when some of the audit procedures performed to meet the requirements of the Uniform Guidance are completed subsequent to the procedures performed on the audit of the financial statements, the Uniform Guidance report on compliance and internal control over compliance should be dated as of the later date when the auditor obtained sufficient appropriate audit evidence to support the report on the audit of compliance. The auditor should adapt and apply the applicable requirements and guidance in AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, to 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 auditor expects to issue the report on the financial statements prior to performing the additional single audit procedures, the auditor ought to 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 audit evidence to satisfy the compliance audit and reporting requirements of the Uniform Guidance.

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 component of the audit on the same date. Accordingly, if the completion of fieldwork for a component is earlier than that of the primary entity, subsequent event procedures should be applied to the component activities from the completion of its fieldwork to the date of the auditor's report on the group financial statements.

The GAS/SA Audit Guide, Paragraph 13.31, explains that when more than one independent auditor is involved in a single audit, the auditor should use professional judgment to adapt and apply the guidance in AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*. However, the GAS/SA Audit Guide, Paragraph 6.58, further explains that due to the unique nature of a compliance audit, "the concept of a component in AU-C section 600 generally should only be applied when other auditors have been *separately engaged* to perform a portion of a Uniform Guidance compliance audit." [Emphasis added.]

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 are submitted, what reports are submitted, reporting packages, and how to bind the reports. Submission of audit reports is discussed in the GAS/SA Audit Guide at Paragraph 13.59.

Audit Report Due Dates

Single Audits. 2 CFR section 200.512(a) states that the reporting package (which includes the audit reports) must be submitted the earlier of 30 calendar days after the reports are received from the auditors or nine months after the end of the audit period. The Federal Audit Clearinghouse (FAC) considers the electronic submission requirement complete when the certification process by both the auditee and auditor have been completed. The Uniform Guidance does not provide an option for extending the due date for the submission of the audit reporting package. However, a footnote to Paragraph 13.59 of the GAS/SA Audit Guide suggests that if the auditor or auditee wants to report that the submission will be late, they do so by contacting the federal cognizant or oversight agency for audit.

Automatic Extension for Reporting Packages for Audits Performed Under the Uniform Guidance Due Prior to September 19, 2016. Although federal agencies are generally no longer granting extensions for filing, the OMB announced an extension until September 19, 2016, for all submissions of reporting packages for 2015 performed under the Uniform Guidance originally due prior to September 19, 2016, because of the delay in release of the 2016 data collection form. The extension is automatic, and no approval is required. This extension applies only to the actual submission of the reporting package to the FAC. The audit itself must be completed and all reports issued according to the timeline in the Uniform Guidance. This extension does not apply to audits performed under OMB Circular A-133 as those audits must continue to follow the deadlines prescribed in OMB Circular A-133 (or FAC extensions).

Loss of Low-risk Auditee Status. To qualify as a low-risk auditee, 2 CFR section 200.520 requires audits to have been performed on an annual basis and the audit reporting package and data collection form submitted to the FAC by the due date for each of the previous two years. Appendix VII of the Compliance Supplement provides suggested steps for determining whether submissions were made by the due date, including searching the FAC database. The Federal Audit Clearinghouse's searchable database can be accessed at **https://harvester.census.gov/facweb**.

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 2 CFR section 200.508(a) indicate that the auditee (recipient or subrecipient) is responsible for ensuring submission of the audit reports to appropriate government officials or organizations. The Yellow Book, at Paragraph 4.45(c), states that the auditor should clarify report distribution responsibilities with the party engaging the auditor. Further, if the audit firm is responsible for report distribution, it should reach agreement about which officials or organizations are to 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.

Best practices suggest that auditors submit the reports only to the engaging entity (client). In instances when it is not possible or practical for the auditor to avoid submitting the reports, best practices suggest 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 the *Confidential Client Information Rule* (ET 1.700.001) of the AICPA's *Code of Professional Conduct*, which prohibits a member from disclosing confidential client information without the specific consent of the client.

2 CFR section 200.512(d) states that the data collection form and the reporting package must be submitted electronically to the Federal Audit Clearinghouse, which is done through the Internet Data Entry System (IDES). Both the auditor and the auditee have responsibilities in the submission and certification process through IDES. This requires 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.

The Uniform Guidance requires that, except for Indian tribes electing otherwise, the reporting package and data collection form must be made available for public inspection through the FAC. The GAS/SA Audit Guide, Paragraph 13.57, indicates that both the auditee and the auditor have a responsibility to ensure their portions of the reporting package do not include protected personally identifiable information (PII). PII includes an individual's first name (or first initial) and last name combined with other types of personal information, such as Social Security Number; passport number; bank or credit card numbers; clearances; biometrics; birth date and place; mother's maiden name; medical, criminal, and financial records; educational transcripts; etc. The GAS/SA Audit Guide, Paragraph 13.46 states that auditors must ensure that they do not include any protected PII in the findings described in the schedule of findings and questioned costs as well as the auditor's reports.

Additional Electronic Submission Requirements of Certain Federal Agencies. In addition to the reporting requirements under the Uniform Guidance, several federal agencies have issued regulations requiring that certain financial and compliance information be submitted electronically (for example, the financial and reporting compliance requirements of the U.S. Department of Housing and Urban Development through HUD REAC). Reporting under those regulations does not replace the applicable submission requirements to the Federal Audit Clearinghouse.

Submission by Subrecipients. Under the Uniform Guidance, subrecipients are only required to submit the reporting package electronically to the FAC. There is no longer an additional requirement for subrecipients to provide a copy to pass-through entities. (As discussed in the following paragraph, under certain circumstances, Indian tribes have to submit the reporting package to pass-through entities and make it publicly available.) The GAS/ SA Audit Guide, Paragraph 13.66, however, reminds auditors that state laws may still require submission of subrecipient reports to the pass-through entity and may have other subrecipient submission requirements that are not required by the Uniform Guidance.

The reporting package must include a statement signed by a senior-level representative of the auditee certifying that the reporting package does not contain protected personally identifiable information and authorizing the Federal Audit Clearinghouse to make the reporting package publicly available on a website. However, Indian tribes may elect to not authorize the Federal Audit Clearinghouse to make the reporting package publicly available by excluding such authorization in the statement. The Uniform Guidance states that when this exception is elected, the Indian tribe is responsible for submitting the reporting package directly to pass-through entities from which it

received federal awards and for making the reporting package available for public inspection [2 CFR 200.512(b)(2)]. In addition, if the summary schedule of prior audit findings reported the status of findings related to federal awards that a pass-through entity provided, the Indian tribe has to provide a copy of the reporting package to each such pass-through entity.

Clearinghouse Responsibilities. The Federal Audit Clearinghouse has the responsibility to make reporting packages available to the public, 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 **https://harvester.census.gov/facweb**.

Reporting Package

The reporting package referred to in previous paragraphs, as described at 2 CFR section 200.512(c), 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?

The single audit reporting package must be submitted electronically to the Federal Audit Clearinghouse using the Clearinghouse's IDES. However, the auditee (or auditor) may be required to deliver the single audit reporting package in bound reports to other entities. The data collection form is also required to be completed and submitted using the IDES. However, it is not part of the auditor's single audit reporting package and should not be bound with the reporting package.

Neither the Yellow Book nor the Uniform Guidance comment on whether the auditor's reports on internal control, compliance, and the report on the financial statements should be bound together.

There are several ways that auditors and auditees can approach binding reports that are part of the reporting package, including:

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 with which the auditee has to comply. 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. Selection of option b or c may affect how the auditor reports on the schedule of expenditures of federal awards. For example, if the schedule is not presented with the financial statements (such as when, a separate single audit package is issued), the auditor's report on the schedule in relation to the financial statements as a whole might be combined with the report on compliance and on internal control required by the Uniform Guidance.

When practical, best practices suggest that all auditor's reports, the financial statements, and the 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.

Order of the Bound Documents

There are no standards covering in what order the documents should be bound. Best practices indicate that 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 internal control over financial reporting and on compliance and other matters (Yellow Book report).

f. Auditor's report on compliance with requirements applicable to each major program and on internal control over compliance (Uniform Guidance major program compliance report).

g. Schedule of findings and questioned costs.

h. Corrective action plan.

Other sequences that take into account the binding option selected may also be acceptable.

Table of Contents

Best practices suggest 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 above, but it should include the exact title of each report.

Revising a Submitted Report

Sometimes it may be necessary to revise a reporting package and data collection form (i.e., the report) after they have been submitted. As discussed in Lesson 1, revising the form and reporting package, or just the reporting package, is done electronically through the Federal Audit Clearinghouse's IDES system. Revising a submitted report requires the certification to be completed again; both the auditor and the auditee have to certify the revised report before it can be submitted to the FAC. Detailed instructions for revising submitted reports for submissions associated with the 2013-2015 data collection form are included in the document, "Internet Data Entry System (IDES) User Manual," which can be accessed at **https://harvester.census.gov/facides/Files/IDES%202013-2015%20User%20Manual.pdf.** Detailed instructions for revising submitted reports for submissions associated with the 2016 data collection form are included in the document "Internet Data Entry System (IDES) Instructions," which can be accessed at **https://harvester.census. gov/facides/Files/IDES%20Instructions%20UG%202016.pdf.**

REPORT ON THE FINANCIAL STATEMENTS

As indicated in Exhibit 2-1 and Exhibit 2-2, audits performed under the Yellow Book and the Uniform Guidance include reporting on the financial statements in accordance with generally accepted auditing standards. The purpose of this lesson is to discuss the various audit reports that are unique to Uniform Guidance compliance audits. This lesson will, therefore, discuss only selected items (those unique to the single audit process) relative to the auditor's report on the basic financial statements.

References to *Government Auditing Standards*

The Yellow Book, at Paragraph 4.18, states that when auditors comply with all applicable GAGAS requirements, they should include a statement in the auditor's 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 auditor's report(s) on internal control over financial reporting and on compliance and other matters, as well as the other auditor's reports issued in a single audit, should refer to *Government Auditing Standards*.

The Yellow Book, beginning at Paragraph 2.24, provides guidance for referring to GAGAS requirements when the auditor follows *Government Auditing Standards*. Two types of "compliance statements" about adherence to these standards in reports issued in single audit engagements are described:

a. An *unmodified GAGAS compliance statement* states the audit was performed in accordance with *Government Auditing Standards*. This type of statement should be used when (1) all unconditional and applicable 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*. (The Yellow Book, at Paragraph 2.24, states that situations when modified compliance statements would be used also include scope limitations, such as restrictions on access to records, government officials, or other individuals.)

If a Yellow Book requirement is not followed, the auditor should document the reason and the impact on the audit and on the auditor's conclusions. Under the Yellow Book, the auditor should 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. listed earlier in this section, 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 AU-C 700, *Forming an Opinion and Reporting on Financial Statements*. Paragraph 4.49 and the illustrative reports in Chapter 4 of the GAS/SA 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, Paragraph 4.18 of the Yellow Book does not require the auditor's report to specifically cite *Government Auditing Standards*. The separate report on the financial statements would need to conform only to the requirements of generally accepted auditing standards. Paragraph 4.06 of the GAS/SA Audit Guide provides similar guidance.

References to Separately Issued Internal Control and Compliance Report

When providing an opinion or disclaiming an opinion on financial statements, *Government Auditing Standards* requires auditors to also report on internal control over financial reporting and on compliance with provisions of laws, regulations, contracts, and grant agreements. The Yellow Book provides two options. The auditor's report on the financial statements should either:

- Describe the scope and the results of testing internal control over financial reporting and compliance with provisions of laws, regulations, contracts, and grant agreements, or

- Include a statement that refers to a separate report on internal control over financial reporting and compliance and also states that it is an integral part of a *Government Auditing Standards* audit in considering the entity's internal control over financial reporting and compliance. The GAS/SA Audit Guide, Paragraph 4.11, recommends that the reference to the separate report indicate that it does not provide an opinion on internal control over financial reporting or on compliance. The scope and the results of testing internal control over financial reporting and compliance with provisions of laws, regulations, contracts, and grant agreements should be described in the separate report.

The AICPA does not present report examples combining the report on the financial statements with the report on internal control over financial reporting and compliance. Also, because Paragraph 4.11 of the GAS/SA Audit Guide recommends issuing separate reports, best practices suggest issuing separate reports. When separate reports are issued, AU-C 700.37 states that these additional reporting responsibilities should be addressed in a separate "Other Reporting Responsibilities" section in the auditor's report on the financial statements.

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 provisions of laws, regulations, 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.

AU-C 700.37 provides that the reference to the Yellow Book report on internal control over financial reporting and compliance with laws, regulations, and provisions of contracts and grant agreements should be included in a separate section of the auditor's report on the financial statements. The question has arisen as to whether the auditor's report on the financial statements should also refer to the additional report on compliance and on internal control over compliance required by the Uniform Guidance. AU-C 700.A32 indicates that when the auditor performs a compliance audit in accordance with GAAS, *Government Auditing Standards*, and a governmental audit requirement (e.g., a single audit), the reporting requirements in AU-C 935 apply. The Appendix at AU-C 935.A41 specifically states that AU-C 700.37 is not applicable to a compliance audit. Accordingly, best practices indicate that the reference to the Uniform Guidance report should 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 and other matter. has to 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.

Reporting on Supplementary Information

In a Uniform Guidance compliance audit, the auditor reports on whether the schedule of expenditures of federal awards (SEFA) is fairly stated in relation to the financial statements as a whole. AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, provides guidance on the auditor's responsibilities when the auditor is engaged to report on whether supplementary information is fairly stated in all material respects in relation to the financial statements as a whole. It indicates that *supplementary information* is information, other than required supplementary information (RSI), that is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented. AU-C 725 applies, for example, when the auditor issues an in-relation-to opinion on the SEFA.

Issuing an AU-C 805 Opinion on the Schedule of Expenditures of Federal Awards. In certain circumstances, the auditor may be engaged to issue a stand-alone opinion on the schedule of expenditures of federal awards under AU-C 805, *Special Considerations—Audits of Single Financial Statement and Specific Elements, Accounts, or Items of a Financial Statement*. Although this engagement would be performed under Government Auditing Standards, because the SEFA (i.e., the single financial statement) presents only the activities of the federal programs, the auditor is not required to issue a separate report to meet the reporting requirements of Government Auditing Standards.

Basis of Accounting

A question that often arises is whether *Government Auditing Standards* or the Uniform Guidance requires the basic financial statements to be presented in accordance with generally accepted accounting principles (GAAP). The answer is no. (Paragraph 2.07 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. However, to qualify as a low-risk auditee, 2 CFR 200.520(b) requires an unmodified opinion on financial statements prepared in accordance with GAAP, or a basis of accounting required by state law, for each of the two preceding audit periods. In addition, 2 CFR 200.515(a) requires the auditor to issue an opinion (or disclaimer of opinion) on whether the financial statements are presented fairly in all material respects in accordance with GAAP.

If the client prepares its financial statements in accordance with a special purpose framework, the auditor should follow the guidance in AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*. AU-C 800 replaces the term *other comprehensive basis of accounting* (OCBOA) with the term *special purpose framework*. A special purpose framework is defined at AU-C 800.07 as a financial reporting framework other than GAAP that is either the cash, tax, regulatory, contractual, or other basis of accounting. AU-C 800.07, as amended, defines *other basis* as a basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items in the financial statements.

AU-C 800.18–.20 states that the auditor's report on special purpose financial statements should include the following:

- When management has a choice of financial reporting frameworks, a reference, in the management's responsibility section, to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.
- When the financial statements are prepared in accordance with a regulatory or contractual basis of accounting, a description of the purpose for which the financial statements are prepared or a reference to a note in the financial statements that contains that information.

- Except when the financial statements are prepared in accordance with a regulatory basis and are intended for general use, an *emphasis-of-matter paragraph* under an appropriate heading that, among other things, states that the special purpose framework is a basis of accounting other than GAAP.

- When the financial statements are prepared in accordance with a regulatory or contractual basis of accounting and the financial statements and auditor's report are intended solely for use by those within the entity, the regulatory agencies to whose jurisdiction the entity is subject, or the parties to the contract or agreement, an *other-matter paragraph* under an appropriate heading that restricts the use of the report.

- When the auditor is required by law or regulation to use a specific layout, form, or wording of the auditor's report, specific elements prescribed in AU-C 800.22.

Except as discussed later in this lesson, the auditor's report should include an *emphasis-of-matter* paragraph, under an appropriate heading (such as, Basis of Accounting), that does the following:

a. Indicates that the financial statements are prepared in accordance with the applicable special purpose framework,

b. Refers to the note to the financial statements that describes that framework, and

c. States that the special purpose framework is a basis of accounting other than GAAP.

Except as discussed later in this lesson, the auditor's report on special purpose financial statements prepared in accordance with a contractual basis of accounting or a regulatory basis of accounting (but not intended for general use) should include an *other-matter* paragraph, under an appropriate heading (such as, "Restriction on Use"), that restricts the use of the auditor's report solely to those within the entity, the parties to the contract or agreement, or the regulatory agencies to whose jurisdiction the entity is subject.

When the financial statements are prepared in accordance with the cash or modified cash basis of accounting, a restricted use other-matter paragraph is not required. However, SLG, Paragraph 16.15, explains that the auditor might consider it necessary in the circumstances to restrict the use of the auditor's report and that the auditor is not precluded from including an other-matter paragraph that restricts its use.

When reporting on regulatory basis financial statements that are intended for general use, AU-C 800.21 states that the auditor does not include the emphasis-of-matter or other-matter paragraphs. SLG, Paragraph 16.16, explains that, instead, the auditor should express a modified opinion about whether the financial statements are prepared, in all material respects, in accordance with GAAP. SLG, Paragraph 16.17, Example A-2, illustrates an adverse opinion. The report also includes a separate paragraph expressing an opinion about whether the financial statements are prepared in accordance with the special purpose framework.

Noncompliance Findings

Paragraph 4.23 of the Yellow Book states that the Yellow Book report on internal control over financial reporting and compliance should include (a) instances of fraud and noncompliance with provisions of laws or regulations that have a material effect on the audit or other financial data significant to the audit objectives, and any other instances that warrant the attention of those charged with governance; (b) noncompliance with provisions of contracts and grant agreements that has a material effect on the determination of financial statement amounts or other financial data significant to the audit objectives; and (c) abuse that has a material effect, either qualitatively or quantitatively, on the audit. Noncompliance with provisions of contracts and grant agreements that has an effect that is less than material but warrants the attention of those charged with governance should be communicated in writing to officials of the audited entity. Communication of fraud, noncompliance with provisions of laws, regulations, contracts, or grant agreements, or abuse that does not warrant the attention of those charged with governance is a matter of professional judgment.

In addition to their effect on the internal control and compliance report, the effects of the auditor's findings *should be considered* when reporting on the financial statements. Generally, such findings may be material to a specific federal program, but not to the 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 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 report modifications in more detail.

Types of Modifications to the Standard Auditor's Report

AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, discusses three types of modifications to the auditor's standard report.

- Qualified opinions.
- Adverse opinions.
- Disclaimers of opinion.

The first modification qualifies the auditor's opinion on the financial statements, stating that, except for the effects of the matters to which the qualification relates, the financial statements are fairly presented in accordance with GAAP. Adverse opinions state that financial statements are not fairly presented in accordance with GAAP. Disclaimers of opinion do not express an opinion on the financial statements to which they relate.

The auditor should express an adverse opinion when he or she has concluded that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements. The auditor should disclaim an opinion when he or she has been unable to obtain sufficient appropriate audit evidence on which to base the opinion, and has concluded that the possible effects of undetected misstatements, if any, could be both material and pervasive. AU-C 705.06 explains that a matter is *pervasive* to the financial statements when, in the auditor's professional judgment, it is:

- not confined to specific elements, accounts, or items in the financial statements;
- confined, but represents or (could represent) a substantial portion of the financial statements; or
- relevant to disclosures that are essential to the users' understanding of the financial statements.

The type of modification depends on the specific situation. Exhibit 2-3 displays how that determination is made.

Exhibit 2-3

Determining the Type of Modification to the Auditor's Opinion

Type of Modification	AU-C Reference	Was sufficient appropriate audit evidence obtained?[a]	Does the auditor conclude that misstatements (individually or in the aggregate) are material?	Could possible effects of undetected misstatements, if any, be material?	Are misstatements pervasive[b] to the financial statements?
Qualified	AU-C 705.08	Yes	Yes	—	No
Qualified	AU-C 705.08	No	—	Yes	No
Adverse	AU-C 705.09	Yes	Yes	—	Yes
Disclaimer	AU-C 705.10	No	—	Yes	Yes

Notes:

[a] The auditor's inability to obtain sufficient appropriate audit evidence is also referred to as a limitation on the scope of the audit (see AU-C 705.A8). This may arise from circumstances beyond the control of the entity, circumstances relating to the nature or time of the auditor's work, or a limitation imposed by management.

[b] *Pervasive* is defined earlier in this lesson.

* * *

The form and content of the auditor's report when the opinion is modified include specific elements and section headings required by AU-C 700, *Forming an Opinion and Reporting on Financial Statements*. In situations where the auditor modifies the opinion, the auditor includes a separate paragraph in the report and uses an appropriate heading.

GAAP Departures. According to AU-C 705.17, the auditor's report should be modified by including a paragraph with a heading, "Basis for Qualified Opinion," or, "Basis for Adverse Opinion," immediately before the opinion paragraph, describing the matter giving rise to the modification. The basis for modification paragraph should describe and quantify the principal effects of the misstatement unless impracticable, in which case the paragraph should state that the effects are not reasonably determinable. The opinion paragraph should have an appropriate header (e.g., "Qualified Opinion" or "Adverse Opinion") and should be modified for the effects of the GAAP departure using the term *except for* when the opinion is qualified, or, for an adverse opinion, should state that the financial statements "do not present fairly" the financial position, changes in financial position, and cash flows in accordance with GAAP.

Scope Limitations. AU-C 705.A8 explains that an auditor may be unable to obtain sufficient appropriate audit evidence (also referred to as a scope limitation) when the following arise:

a. Circumstances beyond the control of the entity.

b. Circumstances relating to the nature or timing of the auditor's work.

c. Limitations imposed by management.

If sufficient appropriate evidence can be obtained by performing alternative procedures, the inability to perform a specific procedure is not a scope limitation.

If the auditor cannot obtain sufficient appropriate evidence, the auditor should express a qualified opinion if the possible effects of undetected misstatements could be material, but not pervasive. If the possible effects could be pervasive, the auditor should disclaim an opinion. If the scope limitation is imposed by management and is material or pervasive, the auditor should request that management remove the limitation. If management refuses, the auditor should do the following:

a. Communicate the matter to those charged with governance.

b. If sufficient appropriate evidence cannot be obtained by performing alternative procedures, and the auditor concludes the possible effects of an undetected misstatement could be material and pervasive, either disclaim an opinion, or, when practicable, withdraw from the audit.

Qualified Opinion because of a Scope Limitation. When the auditor's opinion is qualified because of a scope limitation, the auditor should include a paragraph with the heading "Basis for Qualified Opinion" immediately before the opinion paragraph that describes the reasons for the auditor's inability to obtain sufficient appropriate evidence. The opinion paragraph should state that, except for the possible effects of the matters described in the basis for modification paragraph, the financial statements are presented fairly. The opinion paragraph should be headed, "Qualified Opinion."

Disclaimer of Opinion because of a Scope Limitation. If the possible effects on the financial statements of the scope limitation could be pervasive, the auditor should disclaim an opinion. SLG, Paragraph 15.29, explains that "a disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable the auditor to form an opinion on the financial statements . . . or when the client imposes restrictions that significantly limit the scope of the audit." The auditor should include a paragraph with the heading "Basis for Disclaimer of Opinion" immediately before the opinion paragraph that describes the circumstances for disclaiming an opinion. The opinion paragraph should use a heading that includes "Disclaimer of Opinion."

Emphasis-of-matter and Other-matter Paragraphs

Certain circumstances, although not affecting the auditor's opinion, may require that the auditor's report include an emphasis-of-matter or other-matter paragraph as provided by AU-C 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*. Even when not required, such paragraphs may be included at the auditor's discretion. The form and content of the auditor's report, when an emphasis-of-matter or other-matter paragraph is included, incorporate specific elements and section headings required by AU-C 700, *Forming an Opinion and Reporting on Financial Statements*.

The terms *emphasis-of-matter* and *other-matter* differentiate matters included in an auditor's report as follows:

- *Emphasis-of-matter Paragraph.* This paragraph refers to a matter appropriately disclosed or presented in the financial statements that, in the auditor's professional judgment, should be emphasized due to its importance to the user's understanding of the financial statements. GAAS requires an emphasis-of-matter paragraph for the following situations in certain circumstances (AU-C 706.A14):
  - Subsequent events and subsequently discovered facts (AU-C 560.16c). (AU-C 560.16c allows auditors to use either an emphasis-of-matter paragraph or an other-matter paragraph.)
  - Going concern (AU-C 570A.15–.16 and AU-C 570.24–.25).
  - Consistency (AU-C 708.08–.09 and AU-C 708.11–.13).
  - Special purpose frameworks (AU-C 800.19 and AU-C 800.21).
- *Other-matter Paragraph.* This paragraph refers to a matter that is not presented or disclosed in the financial statements that, in the auditor's opinion, is relevant to the user's understanding of the audit, the auditor's responsibilities, or the auditor's report. GAAS requires an other-matter paragraph in the following situations in certain circumstances (AU-C 706.A15):
  - Subsequent events and subsequently discovered facts (AU-C 560.16c). (AU-C 560.16c allows auditors to use either an emphasis-of-matter paragraph or an other-matter paragraph.)
  - Reporting on prior-period financial statements (AU-C 700.54–.55 and AU-C 700.57–.58).
  - Other information (AU-C 720.12).
  - Supplementary information and required supplementary information (AU-C 725.09).
  - Restricting the use of contractual basis or regulatory basis financial statements (AU-C 800.20).
  - Alert that restricts the use of the auditor's report (AU-C 905.06–.07). Such a restriction or the inclusion of other alerts is included in an other-matter paragraph and is generally required in the following instances that may be applicable to an audit of a governmental entity or nonprofit organization (AU-C 905.11 and AU-C 905.A12):
    - Separate report on supplementary information (AU-C 725.A16). AU-C 725.A16 states that the auditor may consider including the alert.

- Contractual or regulatory basis financial statements not intended for general use (AU-C 800.20, .A26–.A27, and .A33).

- Yellow Book reports (AU-C 905.11) and compliance audit reports (AU-C 935.30 and AU-C 935.31i). AU-C 905.11 prescribes a different alert for these engagements. AU-C 905.11 explains that for an audit performed in accordance with *Government Auditing Standards*, the auditor's reports issued pursuant to AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*; AU-C 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements*; or AU-C 935, *Compliance Audits*, or AU-C 940, *An Audit of Internal Control over Financial Reporting That Is Integrated With an Audit of Financial Statements,* should include an alert that (a) describes the purpose of the auditor's written communication and (b) states that the auditor's written communication is not suitable for any other purpose.

In situations where the auditor includes an emphasis-of-matter or other-matter paragraph in the auditor's report, the paragraph follows the opinion paragraph and has an appropriate section heading.

Communicating Significant Matters. AU-C 706.A2 provides examples of important matters, such as significant related party transactions or an unusually important subsequent event, which auditors may wish to highlight in a separate paragraph in their report on the financial statements. This information may satisfy public interest in the operations of entities that receive federal awards as well as in the entities that administer them.

The decision about whether to communicate this information is a matter of professional judgment. Examples of other types of matters the auditor may communicate include the following:

- Significant uncertainties or concerns about the fiscal sustainability of an entity 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.

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 4.75 of the GAS/SA 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 Auditor's Responsibility section of the report on the financial statements should be revised to indicate the portion of the entity that was not audited in accordance with *Government Auditing Standards*. For example, the following language may be added as a 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 41 to Paragraph 4.75 of the GAS/SA 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.

Confidential or Sensitive Information

The Yellow Book provides guidance about the auditor's considerations 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 containing such information and distribute the reports only to persons authorized by law or regulation to receive them.

Paragraph 4.44 of 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 orally when confidential or sensitive information is involved.

The auditor should also be familiar with the discussion in this lesson on protected personally identifiable information (PII). Both the auditee and auditor are responsible for ensuring the reporting package does not include PII.

Reporting on Restated Financial Statements

GAAS establishes requirements for auditors who become aware of new information that could have affected their report on previously-issued financial statements. If auditors become aware of information that might have affected their opinion, they should consider the guidance in AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, in determining an appropriate course of action.

SELF-STUDY QUIZ

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

9. Which of the following statements regarding dating the auditor's report on financial statements is correct?

    a. Generally, the auditor's report on the financial statements should be dated some time after the fieldwork is complete.

    b. Auditors are required to physically have management's representation letter on the date of the auditor's report.

    c. Management does not need to review the final representation letter prior to the auditor's report date.

    d. If a subsequent event requires revision of the financial statements after the date of the auditor's report but before they are issued, the date of the report must be changed to the later date.

10. Auditees and auditors may be required to deliver the single audit reporting package in bound reports to other entities. Which of the following should **not** be included in the reporting package?

    a. Data collection form.

    b. Summary schedule of prior audit findings.

    c. Corrective action plan.

    d. Schedule of expenditures of federal awards.

11. When the auditor follows *Government Auditing Standards,* 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.

12. B.J. is preparing the auditor's standard report for the City of Elk. He should express which of the following opinions when he concludes that misstatements, in the combined or separately, are material and pervasive to the financial statements?

    a. Adverse.

    b. Qualified.

    c. Disclaimer.

13. Which one of the following is **not** considered a scope limitation as explained in AU-C 705.A8?

    a. Performance of alternative procedures.

    b. Conditions beyond the control of the entity.

    c. Conditions concerning the nature or timing of the auditor's work.

    d. Management limitations.

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. Which of the following statements regarding dating the auditor's report on financial statements is correct? **(Page 51)**

    a. Generally, the auditor's report on the financial statements should be dated some time after the fieldwork is complete. [This answer is correct. AU-C 700.41, *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 on the financial statements. This will usually be a date later than the completion of fieldwork because it encompasses review of the audit documentation; preparation of financial statements and disclosures, and single audit reports; and obtaining management's assertion that they have taken responsibility for the financial statements.]

    b. Auditors are required to physically have management's representation letter on the date of the auditor's report. [This answer is incorrect. The management's representation letter should be dated as of the date of the auditor's report on the financial statements. AU-C 580.A27 indicates that this requirement does not mean that the auditor needs to physically have management's representation letter on the date of the auditor's report.]

    c. Management does not need to review the final representation letter prior to the auditor's report date. [This answer is incorrect. Management will need to have reviewed the final representation letter and confirmed to the auditor that they will sign the letter without exception on or before the date of the auditor's report.]

    d. If a subsequent event requires revision of the financial statements after the date of the auditor's report but before they are issued, the date of the report must be changed to the later date. [This answer is incorrect. If a subsequent event requires revision of the financial statements 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.]

10. Auditees and auditors may be required to deliver the single audit reporting package in bound reports to other entities. Which of the following should **not** be included in the reporting package? **(Page 55)**

    a. Data collection form. [This answer is correct. The data collection form is required to be completed and submitted using the IDES. However, it is not part of the auditor's single audit reporting package and should not be bound with the reporting package.]

    b. Summary schedule of prior audit findings. [This answer is incorrect. The reporting package, as described in 2 CFR section 200.512(c), includes the summary schedule of prior audit findings.]

    c. Corrective action plan. [This answer is incorrect. The reporting package, as described in 2 CFR section 200.512(c), includes the corrective action plan.]

    d. Schedule of expenditures of federal awards. [This answer is incorrect. The reporting package, as described in 2 CFR section 200.512(c), includes the schedule of expenditures of federal awards.]

11. When the auditor follows *Government Auditing Standards,* which of the following compliance statements should be used when all applicable unconditional and presumptively mandatory Yellow Book requirements have been followed? **(Page 57)**

    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 when: (1) all applicable 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.]

12. B.J. is preparing the auditor's standard report for the City of Elk. He should express which of the following opinions when he concludes that misstatements, in the combined or separately, are material and pervasive to the financial statements? **(Page 61)**

a. Adverse. [This answer is correct. Adverse opinions state that financial statements are not fairly presented in accordance with GAAP. Disclaimers of opinion do not express an opinion on the financial statements to which they relate. The auditor should express an adverse opinion when he or she has concluded that misstatements individually or in the aggregate, are both material and pervasive to the financial statements.]

b. Qualified. [This answer is incorrect. The qualified opinion, which is the first modification, qualifies the auditor's opinion on the financial statements, stating that, except for the effects of the matters to which the qualification relates, the financial statements are fairly presented in accordance with GAAP.]

c. Disclaimer. [This answer is incorrect. The auditor should disclaim an opinion when he or she has been unable to obtain sufficient appropriate audit evidence on which to base the opinion, and has concluded that the possible effects of undetected misstatements, if any, could be both material and pervasive.]

13. Which one of the following is **not** considered a scope limitation as explained in AU-C 705.A8? **(Page 62)**

a. Performance of alternative procedures. [This answer is correct. If sufficient appropriate evidence can be obtained by performing alternative procedures, the inability to perform a specific procedure is not a scope limitation.]

b. Conditions beyond the control of the entity. [This answer is incorrect. AU-C 705.A8 explains that the auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from circumstances that are beyond the control of the entity.]

c. Conditions concerning the nature or timing of the auditor's work. [This answer is incorrect. AU-C 705.A8 explains that the auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from circumstance relating to the nature or timing of the auditor's work.]

d. Management limitations. [This answer is incorrect. AU-C 705.A8 explains that the auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from limitations imposed by management.]

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 the Uniform Guidance and the provisions of state law or grant contracts. As indicated at Exhibit 2-1 and Exhibit 2-2, *Government Auditing Standards* requires reporting on internal control over financial reporting, and on compliance with laws, regulations, contracts, and grant agreements and other matters. Such reporting is required regardless of whether the auditor finds internal control deficiencies or instances of noncompliance. The illustrative auditor's reports included in the Appendix to Chapter 4 of the GAS/SA 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 single reports.

Paragraph 4.07 of the GAS/SA Audit Guide states—

> Auditors should communicate in the report on internal control over financial reporting and compliance, based upon the work performed, (a) significant deficiencies and material weaknesses in internal control; (b) instances of fraud and noncompliance with provisions of laws or regulations that have a material effect on the financial statements and any other instances that warrant the attention of those charged with governance; (c) noncompliance with provisions of contracts or grant agreements that has a material effect on the financial statements; and (d) abuse that has a material effect, either qualitatively or quantitatively. Auditors report on internal control and compliance regardless of whether or not they identify internal control deficiencies or instances of noncompliance.

The footnote to Paragraph 4.07 explains that the GAS/SA Audit Guide uses the shorter phrase, *material effect on the financial statements*, rather than the full term, *material effect on the financial statements or other financial data significant to the audit objectives*.

Reporting on Internal Control

When providing an opinion or disclaiming an opinion on financial statements, *Government Auditing Standards* requires that auditors also report on internal control over financial reporting and on compliance with provisions of laws, regulations, contracts, and 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 the financial statements. The GAS/SA 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 control over financial reporting and compliance with provisions of laws, regulations, contracts, and grant agreements.
- State whether the tests performed provide sufficient, appropriate evidence to support opinions on the effectiveness of internal control and on compliance with provisions of laws, regulations, contracts, and grant agreements.
- Communicate significant deficiencies and material weaknesses identified as a result of the audit work performed.

When auditors report separately on internal control over financial reporting and on compliance with provisions of laws, regulations, contracts, and grant agreements, the guidance for the required disclosures and references described earlier in this lesson for the auditor's report on the financial statements should be followed.

Government Auditing Standards requires the report on internal control to disclose significant deficiencies and material weaknesses in internal control over financial reporting based on the audit of the financial statements. The

Yellow Book, at Paragraph 4.24, explains that the AICPA requirements to communicate significant deficiencies and material weaknesses identified during an audit form the basis for reporting them under *Government Auditing Standards*. Thus, 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 GAAS. Because the Yellow Book adopts the GAAS internal control communication requirements, audits performed under *Government Auditing Standards* will meet the GAAS (AU-C 265) requirements for internal control communications. An Emphasis Point at Paragraph 4.54 of the GAS/SA Audit Guide points out that because the Yellow Book incorporates the AICPA Statements on Auditing Standards, the definitions in the auditor's report should be based on the definitions found in GAAS.

Before the report is issued, the auditor may obtain sufficient appropriate evidence that a control deficiency has been remediated. The GAS/SA Audit Guide, Paragraph 4.14, explains that the AU-C 265 requirement for the auditor to communicate to those charged with governance, in writing and on a timely basis, the significant deficiencies or material weaknesses that were identified during the audit, includes those that were remediated during the audit.

Report Elements. The GAS/SA Audit Guide, Paragraph 4.54, lists the following basic elements to be included in the auditor's standard report on internal control over financial reporting and compliance for audits conducted under the Yellow Book:

- A title that includes the word independent.
- An appropriate addressee.
- A statement that the auditor has audited the financial statements of the entity, a reference to the auditor's report on those financial statements, a description of the nature of any opinion modification, the period covered by the report, and the date of the 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 section with the heading "Internal Control Over Financial Reporting."
- A statement that, in planning and performing the audit of the financial statements, the auditor considered the entity's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, the auditor does not express an opinion on the effectiveness of the entity's internal control.
- The definitions of *deficiency in internal control*, *significant deficiency*, and *material weakness*. A note to the GAS/SA Audit Guide, Paragraph 4.54g, clarifies that the definition of *significant deficiency* is not required to be included in the report when no such deficiencies were identified. However, the definitions of *deficiency in internal control* and *material weakness* must be included in the report.
- If no significant deficiencies or material weaknesses have been identified, statements that:
  - The auditor's consideration of internal control was for the limited purpose described in the first paragraph of the section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies.
  - Given the limitations, the auditor did not identify any deficiencies in internal control that are considered to be material weaknesses. However, material weaknesses may exist that have not been identified.
- If significant deficiencies (but no material weaknesses) are identified:
  - A statement that the auditor's consideration of internal control was for the limited purpose described in the first paragraph of the section and was not designed to identify all deficiencies in internal control

that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that have not been identified.

- A statement that, given these limitations, during the audit the auditor did not identify any deficiencies in internal control that were considered to be material weaknesses.

- A statement that certain deficiencies in internal control over financial reporting were identified that the auditor considers to be significant deficiencies.

- A description of those significant deficiencies, including the title of the schedule where the findings are reported. (Alternatively the findings may be listed in the report.)

- If material weaknesses and significant deficiencies have been identified:

  - A statement that the auditor's consideration of internal control was for the limited purpose described in the first paragraph of the section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist have not been identified.

  - A statement that certain deficiencies in internal control over financial reporting were identified that the auditor considers to be material weaknesses and significant deficiencies.

  - A description of the material weaknesses and significant deficiencies, including the title of the schedule where the findings are reported. (Alternatively, the findings may be listed in the report.)

- A section with the heading "Compliance and Other Matters."

- A statement that, as part of obtaining reasonable assurance about whether the financial statements are free from 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.

- If no noncompliance or other matters have been identified that are required to be reported, a statement that the results of the tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

- If noncompliance or other matters have been identified that are required to be reported, a statement that the results of the tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and are described in the accompanying schedule of findings and questioned costs.

- If material weaknesses, significant deficiencies, or reportable instances of noncompliance or other matters are identified, a section with the heading "_[Name of Entity]_'s Response to Findings," which includes statements that the entity's response to the findings identified in the audit is described in the accompanying schedule of findings and questioned costs, that _[Name of Entity]_'s response was not subjected to the auditing procedures applied in the audit of the financial statements, and, accordingly, the auditor does not express an opinion on it.

- A section with the heading "Purpose of this Report," which includes statements that (a) the purpose of the report is solely to describe the scope of the testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance, (b) the report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance, and (c) accordingly, this communication is not suitable for any other purpose.

- The manual or printed signature of the auditor's firm.
- The auditor's city and state.
- The date of the auditor's report.

The Yellow Book, at Paragraph 4.24, explains that the AICPA requirements regarding the communication of significant deficiencies and material weaknesses identified during an audit form the basis for reporting significant deficiencies and material weaknesses in a Yellow Book audit. Paragraph 4.23 of the Yellow Book simply states that the Yellow Book reports on internal control over financial reporting and compliance should communicate significant deficiencies and material weaknesses in internal control. If the auditor reports separately on internal control over financial reporting and on compliance with provisions of laws, regulations, contracts, and grant agreements, the guidance for the required disclosures and references described earlier in this lesson for the auditor's report on the financial statements should be followed.

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 auditors should develop the elements of the findings to the extent necessary to achieve the audit objectives.

The Yellow Book, at Paragraph 4.21, 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. The GAS/SA Audit Guide, Paragraph 4.09, explains that the objective of reporting on internal control over financial reporting in a Yellow Book audit is different from the objective of an examination of internal control in accordance with the AICPA Statements on Standards for Attestation Engagements, which is to express an opinion on the design, or the design and operating effectiveness, of internal control. To provide such an opinion, the Yellow Book, at Paragraph 4.21, indicates the auditor would need to plan and perform the examination to obtain a high level of assurance about whether the entity maintained, in all material respects, effective internal control over financial reporting. Issuing an opinion on internal control over financial reporting in a Yellow Book audit is not recommended. However, if such an opinion is issued, it would satisfy the Yellow Book requirement for reporting on internal control. Paragraph 4.09 of the GAS/SA Audit Guide points out, however, that in an audit performed under Government Auditing Standards the auditor would be required to communicate internal control deficiencies, fraud, noncompliance with provisions of laws, regulations, contracts, and grant agreements, and abuse.

Purpose Alert Paragraph—Yellow Book Reports

AU-C 905, *Alert That Restricts the Use of the Auditor's Written Communication*, requires Yellow Book reports on internal control over financial reporting and compliance and other matters to contain a "purpose alert" instead of a restricted use paragraph. The GAS/SA Audit Guide, Paragraph 4.21, explains that, according to AU-C 905.11, the general alert language (i.e., the restricted use language) in AU-C 905.07 should not be used when the engagement is performed in accordance with *Government Auditing Standards* and the auditor's written communication for that engagement is issued in accordance with AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit* [or AU-C 935, *Compliance Audits* (according to AU-C 905.11)]. Instead, the alert should describe the purpose of the auditor's written communication and state that it is not suitable for any other purpose. The GAS/SA Audit Guide and AU-C 905.A11 further explain that different alert language is used in a Yellow Book audit because *Government Auditing Standards* considers the auditor's written communication issued in the report on internal control over financial reporting and on compliance and other matters to be an integral part of the audit engagement for the purpose of assessing the results of the engagement.

In the above circumstances, the paragraph should describe the purpose of the auditor's written communication and state that the communication is not suitable for any other purpose.

> **Purpose of this Report**
>
> The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed

in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Reporting on Fraud, Noncompliance, and Abuse

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 should be disclosed.

The Yellow Book, Paragraph 4.25, states that the auditor's report on internal control and compliance should include relevant information about:

- Instances of fraud and noncompliance with provisions of laws or regulations that have a material effect on the financial statements and any other instances that warrant the attention of those charged with governance
- Noncompliance with provisions of contracts and grant agreements that has a material effect on the financial statements.
- Abuse that is either quantitatively or qualitatively material.

As indicated above, the threshold for reporting fraud and noncompliance with laws or regulations is different from that for reporting noncompliance with contracts and grant agreements. Paragraph 4.26 of the Yellow Book states that noncompliance with provisions of contracts and grant agreements or abuse that has an effect on the financial statements that is less than material but warrants the attention of those charged with governance should be communicated in writing to audited entity officials. Whether and how to communicate fraud, noncompliance with provisions of laws, regulations, contracts, and grant agreements, or abuse that does not warrant the attention of those charged with governance is a matter of professional judgment.

Reporting Views of Responsible Officials

When deficiencies in internal control, fraud, noncompliance, or abuse are reported, the auditor 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. (Best practices indicate that inclusion in the schedule of findings and questioned costs as required by the Uniform Guidance 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 and provide it to the responsible officials to verify that the comments are accurately stated. This summary should be included with the auditor's report.

The auditor should also 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 should indicate that the audited entity did not provide comments.

Reporting on Other Matters

The GAS/SA Audit Guide, Paragraph 4.59, recommends that findings of fraud and abuse that primarily relate to a significant deficiency or material weakness in internal control be reported in the internal control portion of the report. It recommends that other findings of fraud and abuse be reported in the compliance and other matters section of the report.

Management Letters

Noncompliance with provisions of contracts or grant agreements and abuse that have a material effect on the financial statements are communicated in the Yellow Book report on internal control over financial reporting and on compliance and other matters. However, instances of noncompliance with provisions of contracts and grant agreements and abuse with an effect that is less than material but warrants the attention of those charged with governance should also be communicated in writing. The GAS/SA Audit Guide, Paragraph 4.72, explains that this written communication may be done in what is commonly called a management letter.

Developing Audit Findings

The Yellow Book, at Paragraph 4.10, indicates that when developing audit findings such as deficiencies in internal control, fraud, noncompliance, 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 to report 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, best practices indicate 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 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, best practices indicate that the auditor's Yellow Book report on internal control over financial reporting and on compliance and other matters would be modified as follows:

- The name of the audited entity in the report would reflect the status of the entity. Examples are as follows:

  - We have audited, in accordance with the 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 financial statements of the DEF Branch Office of ABC Organization (a nonprofit organization) as of . . .

  - We have audited, in accordance with the 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 financial statements of the Municipal Airport fund of the City of X, State Y, as of . . .

- The report should include a statement describing the nature of any modification of the opinion on the financial statements.

- The report may include additional communications that were included in the auditor's report on the financial statements that were not modifications to the opinion. For example, if the auditor's report on the financial statements included an emphasis-of-matter paragraph due to a going concern uncertainty, it may also be mentioned in the Yellow Book report on internal control over financial reporting and compliance and other matters.

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 auditor's responsibility paragraph of the auditor's

report on internal control over financial reporting and compliance and other matters should be revised to disclose that fact and identify that segment of the reporting entity. The GAS/SA Audit Guide, Paragraph 4.76, indicates that (1) the phrase ", in accordance with the 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," in the first sentence of the scope paragraph would be omitted, and (2) a sentence such as the following would be added to the end of the auditor's responsibility 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* and accordingly this report does not include reporting on internal control over financial reporting or instances of reportable noncompliance associated with [**Government:** Name of Component Unit or Fund/**Nonprofit Organization:** Name of Affiliated Organization or Other Portion of the Reporting Entity].

Introductory Report Paragraphs—Yellow Book Reporting

Government Auditing Standards requires that the auditor's standard report on internal control over financial reporting and on compliance and other matters 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, or disclaimers of opinion, has to be described in the Yellow Book report. The report may, but is not required to, include additional communications that were included in the auditor's report on the financial statements that were not modifications to the opinion. Footnote 31 of the report illustrated at Example 4-3 of the GAS/SA Audit Guide indicates these disclosures are only presented in the first paragraph of the report on internal control over financial reporting and on compliance and other matters. The guidance in the following paragraphs may be useful when modifying the introductory paragraph of the Yellow Book report to meet the requirement to describe any departure from the standard report on the financial statements.

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 on the financial statements, our [opinion OR opinions] on the [Identify affected *opinion units*, such as Major Governmental Funds X and Y.] was qualified because, as discussed in the "Basis for Qualified Opinions on [Major Governmental Funds X and Y]" paragraph in the report on the financial statements, management has not adopted a methodology for reviewing the collectibility of taxes receivable in [Major Governmental Funds X and Y] and, accordingly, has not considered the need to provide an allowance for uncollectible amounts, as required by generally accepted accounting principles.
>
> In our report, our opinion on the financial statements was qualified because, as discussed in the "Basis for Qualified Opinion" paragraph in the report on the financial statements, the organization does not record real estate acquired by gift. As a result, certain real estate was 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 aggregate discretely presented component units was qualified because, as discussed in the "Basis for Qualified Opinion on the Aggregate Discretely Presented Component Units" paragraph in the report on the financial statements, although the financial activities of [Name of Omitted Component Unit] are included in the City's basic financial statements as a discretely presented component unit, the financial statements of [Name of Omitted Component Unit] have not been audited, and we were not engaged to audit the financial statements of [Name of Omitted Component Unit] as part of our audit of the City's basic financial statements.

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 as a whole because, as discussed in the "Basis for Adverse Opinion" paragraph in the report on the financial statements, [Describe the 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, as discussed in the "Basis for Adverse Opinion" paragraph in the report on the financial statements, [Describe the reason for the adverse opinion.] .

Disclaimer of Opinion. The auditor's report at Example 4-9 in Paragraph 4.88 of the GAS/SA Audit Guide illustrates an introductory paragraph of a Yellow Book report on internal control over financial reporting and on compliance and other matters when the auditor disclaims an opinion on the financial statements as a whole.

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 as discussed at paragraph. 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.

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 follow:

> **Going Concern**
>
> Our report on the financial statements includes an emphasis-of-matter 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 emphasis-of-matter paragraph describing a change, discussed in Note X to the financial statements, in the organization's method of accounting for contribution pledges.
>
> **Special Purpose Framework**
>
> Our report on the financial statements includes an emphasis-of-matter paragraph drawing attention to Note X to the financial statements, which states that 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 includes an emphasis-of-matter paragraph drawing attention to Note X to the financial statements, which states that the financial statements include only the financial activities of the primary government and that the financial data for the City's legally separate component units that form the reporting entity are not included.

Other

Our report on the financial statements includes an other-matter paragraph that describes a $60,000,000 bond offering issued subsequent to [Date of Financial Statements] .

Other Auditors

Sometimes an other auditor (referred to as a "component 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 group auditor (i.e., the primary auditor) needs to refer to AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, for guidance on (a) deciding whether he or she may appropriately report as the group auditor, (b) making use of the work of the other auditor, and (c) deciding whether to make reference to the other auditor.

AU-C 600 introduces the term *component auditor* and defines a component auditor as one who performs work on the financial information of a component that will be used as audit evidence for the group audit. If the auditor decides to assume responsibility for work of a component auditor, no reference should be made to the component auditor's work in the auditor's report on the group financial statements. However, if the auditor decides to make reference, then according to AU-C 600.27, the report on the group financial statements should clearly indicate that the component was not audited by the auditor and should indicate the magnitude of the portion of the financial statements audited by the component auditor.

Reference to Component Auditor in Report on Internal Control and Compliance. The GAS/SA Audit Guide, Paragraph 4.78, states that when the work of a component auditor is referred to in the report on the financial statements, the component auditor's involvement should also be acknowledged in the Yellow Book report on internal control over financial reporting and compliance and other matters. The group auditor can do this one of two ways:

a. Reference option: Refer to the component auditor's involvement and indicate that the results of the component audit are not included.

b. Inclusion option: Refer to the component auditor's involvement and include the results of the component audit (for example, material weaknesses, material noncompliance, significant deficiencies, and abuse).

Regardless of which of the preceding options is chosen by the auditor, the group auditor is not responsible for the specific findings of component auditors.

Applicability of AU-C 600 in a Single Audit. Paragraph 202.111 discusses GAS/SA Audit Guide guidance, explaining that the AU-C 600 concept of aggregation risk (i.e., the audit risk that results from the aggregation of component financial information) is not directly applicable to single audits as each major program is being opined on separately. This is because, unlike a financial statement audit, there is no entity-wide opinion on compliance and because the focus of a compliance audit is attribute based (that is, there is either compliance or noncompliance).

PREPARING AND REPORTING ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

As indicated at Exhibit 2-1 and Exhibit 2-2, 2 CFR section 200.515(a) requires, in addition to audited financial statements, an auditor's report on the 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 compliance 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 2-4 provides an example of the schedule. More examples are shown in Paragraph 7.43 of the GAS/SA Audit Guide, and other methods may be equally acceptable. Optional (but recommended) information that may be included is discussed later in this lesson. The minimum requirements for a schedule from 2 CFR section 200.510(b) are listed below and are illustrated in Exhibit 2-4:

a. The period covered by the schedule must be the same as that covered by the financial statements.

b. Total federal awards expended.

c. The federal programs listed individually by federal agency.

d. Total federal awards expended for each individual federal program.

e. Total federal awards expended for each cluster of programs.

f. For research and development clusters, federal awards expended either by individual award or by federal agency and major subdivision within the agency.

g. 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**.)

h. For federal awards received as a subrecipient, the name of the pass-through entity and the identifying number assigned by the pass-through entity.

i. Total amount provided to subrecipients from each federal program.

j. Total federal awards expended for loan or loan guarantee programs, including the value of new loans made during the period, the beginning balance of loans from previous years for which the federal government imposes continuing compliance requirements, and any interest subsidy, cash or administrative cost allowance.

k. The value of federal awards expended in the form of noncash assistance such as food commodities, insurance, and free rent.

l. Note describing the following:

- Significant accounting policies used in preparing the schedule.
- Whether the entity did or did not elect to use the 10 percent de minimis indirect cost rate.
- Balances of loans and loan guarantee programs outstanding at the end of the audit period for loans described in 2 CFR section 200.502(b).

Exhibit 2-4

Schedule of Expenditures of Federal Awards

ABC Organization
Schedule of Expenditures of Federal Awards
for the Year Ended June 30, 20X1[a] [b]

Federal Grantor/Pass-through Grantor/Program or Cluster Title[c]	Federal CFDA Number[c, d]	Pass-through Entity Identifying Number[e]	Passed Through to Subrecipients[f]	Total Federal Expenditures
U.S. Department of Health and Human Services:				
Programs:				
Head Start	93.600		$ 123,965	$ 437,800,
Affordable Care Act (ACA) Grants for New and Expanded Services Under the Health Center Program	93.527			125,000
State Department of Human Services:				
Community Services Block Grant	93.569	K1578		536,000
Foster Care—Title IV-E	93.658	K1783		350,000
Total U.S. Department of Health and Human Services			123,965	1,448,800
U.S. Corporation for National and Community Service program:				
Foster Grandparent Program	94.011			125,000
U.S. Department of Agriculture Summer Food Service Program for Children program:				
State Child Food Program—Commodities	10.559	88888		122,830
Research and development cluster:				
U.S. Department of Health and Human Services programs:				
National Institutes of Health Programs				
Mental Health Research Grants	93.242			475,000
Drug Abuse and Addiction Research Programs	93.279			225,000
XYZ Public Hospital—Heart Research	93.UNKNOWN	548-7		300,000
State Health Department—Food Safety Research	93.SB 573	SB 573		100,000
Total Department of Health and Human Services programs in cluster				400,000
Total research and development cluster				1,100,000
Total expenditures of federal awards			$ 123,965	$ 2,796,630

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[g]

The accompanying schedule of expenditures of federal awards (the Schedule) includes the federal award activity of ABC Organization under programs of the federal government for the year ended June 30, 20X1. The information in this Schedule is presented in accordance with the requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Because the Schedule presents only a selected portion of the operations

of ABC Organization, it is not intended to and does not present the financial position, changes in net assets, or cash flows of ABC Organization.

NOTE B—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES[g]

Expenditures reported on the Schedule are reported on the accrual basis of accounting. Such expenditures are recognized following the cost principles contained in [Identify the applicable cost principles (the Uniform Guidance and/or OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*) OR (the Uniform Guidance and/or OMB Circular A0122, *Cost Principles for Non-profit Organizations*)],[h] wherein certain types of expenditures are not allowable or are limited as to reimbursement.

NOTE C—INDIRECT COST RATE

ABC Organization has elected to use the 10% de minimis indirect cost rate as allowed under the Uniform Guidance.[i]

Notes:

[a] To meet state or other requirements, an auditee may include nonfederal awards. If nonfederal awards are included, they are required to be segregated and clearly designated as nonfederal. The title of the schedule should be modified to indicate that nonfederal awards are included, and the auditor's reporting on the schedule should reference the correct title. As an alternative method, nonfederal awards may be included in a separate schedule.

[b] See other requirements and illustrations in this section.

[c] These federal awards and CFDA numbers and other information, when prepared, were based on an actual schedule. The continued applicability of the information has not been verified.

[d] 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.

[e] When pass-through awards are received, the name of the pass-through entity and the identifying number assigned by the pass-through entity must be included in the schedule. This column may be deleted if there are no pass-through awards.

[f] If there are no awards passed-through to subrecipients, it is recommend to either include the column and leave it blank (or using dashes, depending on the style used) or delete the column and add a note to the schedule stating there were no awards passed through to subrecipients. Because the Uniform Guidance includes the new requirement to include on the face of the schedule the total amount provided to subrecipients from each federal program, best practices suggest including the note disclosure about there being no awards passed through to avoid confusion about whether the minimum schedule requirements were met.

[g] Note A and B meet the Uniform Guidance requirement to disclose the significant accounting policies used in preparing the schedule. The illustrative schedule of expenditures of federal awards in the Appendix at Paragraph 7.43 of the GAS/SA Audit Guide includes the following additional sentence in its summary of significant accounting policies. It may be added if it is applicable to the entity:

> Negative amounts reflected in the schedule represent adjustments or credits resulting from the normal course of business to amounts reported as expenditures in prior years.

[h] The applicable cost principles (the Uniform Guidance or OMB Cost Circular) should be indicated. For example, if the reporting entity has expenditures of federal awards made prior to December 26, 2014 and is a governmental unit, the applicable circular is OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*.

[i] If the entity has not elected to use the 10% de minimis indirect cost rate, the following sentence may be used:

> ABC Organization has elected not to use the 10% de minimis indirect cost rate allowed under the Uniform Guidance.

* * *

CFDA Number Is Not Available. The GAS/SA Audit Guide, Paragraph 7.28, provides guidance on identifying programs in the schedule of expenditures of federal awards when the CFDA number is not available. It provides the following two options:

- Indicate that the CFDA number is not available and include a different identifying number that is available, such as a contract or grant number.
- Apply the guidance in the instructions to the data collection form for when a program does not have a CFDA number. [If the program has a contract or grant number, the number shown as the CFDA number could be the awarding agency's 2-digit prefix listed in an appendix to the instructions (or 99, if the agency is not listed) followed by the contract or grant number. If the program does not have a contract or grant number, the number shown as the CFDA number could be the awarding agency's 2-digit prefix (or 99) followed by "UNKNOWN."]

Schedule May Not Agree with Other Federal Award Reports. Paragraph 7.25 of the GAS/SA Audit Guide alerts auditors that the information included in the SEFA may not fully agree with other reports on federal awards that the recipient has submitted to federal awarding agencies or pass-through entities. For example, AU-C 725 requires that the information in the schedule relate to the same period as the financial statements, but other reports submitted directly to an awarding agency may have been prepared for a different fiscal period or may include cumulative information. Best practices indicate that auditors consider the differences when planning and performing the single audit.

Major Program Designation. Best practices indicate 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. The GAS/SA Audit Guide, Paragraph 7.24, explains that federal agencies or pass-through entities may request additional information to make the schedule easier to use. Best practices indicate that, as a general rule, the more information provided in the schedule, the fewer the follow-up calls from federal agencies. Some 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 or part of this additional information. In other instances, officials may request information not on this list. Although the Uniform Guidance does not obligate the auditee to comply with these requests, it does indicate that the auditee may choose to provide additional information requested by federal awarding agencies and pass-through entities.

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 [2 CFR section 200.510 (b)].

b. The financial information for the schedule is taken from the entity's books, records, and financial statements. The amounts, however, may not agree with the amounts in the Federal Financial Reports (FFR). In some instances, it may be desirable to include a note to the schedule reconciling to the amounts shown in the FFRs.

c. While its inclusion is not required by federal guidelines, nonfederal information, including nonfederal expenditures, may be included in the schedule. According to Paragraph 7.27 of the GAS/SA Audit Guide, when nonfederal information is included, the federal and nonfederal information is required to be presented separately and appropriately labeled. Totals for federal awards must be shown separately and exclude

nonfederal amounts. Often, nonfederal information can be conveniently included in a note to the schedule or in a separate schedule. In addition, the title of the schedule should be modified to indicate that nonfederal awards are included and be correctly referenced in the auditor's report.

d. 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 ought to be disclosed in a note to the schedule.

e. When a pass-through entity is unable to identify the federal portion of an award, 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. Best practices also suggest that the note include, to the extent known, an explanation of why the amount is not determinable.

f. Other information that may be included in the schedule 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:

- Amounts reported in the schedule did not reconcile to the financial records.
- The schedule did not indicate whether awards were direct or pass-through.(Note: It is believed that, under the Uniform Guidance schedule requirements, this deficiency would be addressed by the proper inclusion of a pass-through entity identifying number as required by the schedule. The listing of direct awards separately and labeled as "direct" is no longer required. Awards received as a subrecipient are to include the name of the pass-through entity and the identifying number of the pass-through entity. Also, amounts passed through to subrecipients are included in a separate column on the face of the schedule.)
- The schedule did not clearly indicate the total federal expenditures and/or federal expenditures by program.
- The schedule did not contain required information related to the federal agency and pass-through entities, including CFDA number or other identifying number, and the name of the federal agency or pass through entity and identifying number assigned by the pass-through entity.
- The schedule had inadequate notes (and sometimes no notes).
- Notes to the schedule did not disclose the significant accounting policies used in preparing the schedule.
- The audit documentation did not indicate what procedures were performed relating to the schedule of expenditures of federal awards.
- Internal controls over preparation of the schedule of expenditures of federal awards were not documented.
- The auditor failed to consider modifying the opinion when the following information was missing:
  - CFDA number (or other identifying number when the CFDA number is not available).

  - Name of the federal agency or passthrough entity and the pass-through entity's identifying number.
  - Total federal expenditures for each federal program.
  - Notes describing the significant accounting policies used in preparing the schedule.
- 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 subdivisions 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.

Best practices suggest that auditors consider the deficiencies discussed in the previous paragraphs when conducting and reporting on audits of the schedule of expenditures of federal awards.

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 the Uniform Guidance. Paragraph 7.20 of the GAS/SA Audit Guide indicates that the schedule may be prepared on a different basis of accounting from that in the financial statements. If possible, Best practices indicate that the schedule of expenditures of federal awards should be prepared on the same basis as the financial statements since the auditor states whether the schedule is presented fairly in all material respects in relation to the financial statements. However, Paragraph 7.20 notes that, "in any case, the auditee must clearly disclose the significant accounting policies used in preparing the schedule." Also, while the auditee should 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. Two AICPA practice aids, *Applying OCBOA in State and Local Governmental Financial Statements* and *Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements*, may be useful nonauthoritative guidance when preparing and reporting on special purpose framework financial statements.

Even though the Uniform Guidance does not prescribe the basis of accounting, it does state that determination of when an award is expended must be based on when the activity related to the federal award occurs. Exhibit 2-5 provides guidance for determining when different types of federal awards are expended.

Exhibit 2-5

Basis for Determining When Federal Awards Are Expended

Federal Awards	Basis for Determining When Expended
Grants, cost reimbursement contracts, compacts with Indian tribes, cooperative agreements under the Federal Acquisition Regulations (FAR), 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 by the nonfederal entity
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 Single 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 the amount of the award follows:

> NOTE XX—(NAME OF FEDERAL AWARD)
>
> 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 awarding agency) for the excess (explain why the amount should be billed to the awarding agency).

An example disclosure of program income is as follows:

> NOTE XX—(NAME OF FEDERAL AWARD)
>
> In accordance with terms of the award, 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 provide the subrecipient with the amount of federal funds included in an award that includes both federal and other funds:

> NOTE XX—(NAME OF FEDERAL AWARD)
>
> During the year ended (date), funds totaling $190,000 were received from (name of awarding agency—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 (awarding agency) 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 federal award amounts per the schedule to the amounts reported on the Federal Financial Status Report (FSR) follows:

> NOTE XX—(NAME OF FEDERAL AWARD)
>
> The entity reports its receipts and expenditures to the (Name of Government Agency) on a 12-month award 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:

	Receipts	Expenditures
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	(97,420)	(97,628)
Amounts per the March 31, 20X1 FSR	$ 380,000	$ 378,420

Illustrated Disclosure—Student Financial Assistance

A note disclosing student financial assistance programs follows:

> NOTE XX—STUDENT FINANCIAL ASSISTANCE
>
> The hospital administers a Health Professions Student Loan Program funded by the U.S. Department of Health and Human Services. Balances and transactions relating to this program are included in ABC Organization's basic financial statements. Loans outstanding at the beginning of the year and loans made during the year are included in the federal expenditures presented in the schedule. The balance of the loans outstanding at June 30, 20X2 consists of:

CFDA Number	Program Name	Outstanding Balance at June 30, 20X2
93.342	Health Professions Student Loan Program	$618,629

Student loans	$ 123,423
Administrative cost allowances	18,513
Interest subsidies	6,171
	$ 148,107

Accumulating Information for the Schedule

The requirement to present a schedule of expenditures of federal awards means that the recipient has to identify all of its federal programs (direct and indirect, major and nonmajor) and related awards expended, including separately identifying expenditures of Recovery Act awards. Paragraph 7.16 of the GAS/SA Audit Guide states the

auditor should evaluate the severity of each identified deficiency in internal control that relates to the auditee's ability to prepare a complete and accurate schedule of expenditures of federal awards to determine whether the deficiency, individually or in combination, is a significant deficiency or material weakness in internal control over financial reporting, internal control over compliance, or both. A deficiency in internal control that is determined to be a significant deficiency or material weakness should be reported as a finding in the schedule of findings and questioned costs.

Reporting on the Schedule of Expenditures of Federal Awards Under AU-C 725

2 CFR section 200.515(a) indicates that the auditor's report must include an opinion (or disclaimer of opinion) on whether the schedule of expenditures of federal awards is "fairly stated in all material respects in relation to the financial statements as a whole." This requirement is referring to an "in relation to opinion" on supplementary information based on the requirements of AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*. These standards provide guidance on the auditor's responsibilities when the auditor is engaged to report on whether supplementary information is fairly stated in all material respects in relation to the financial statements as a whole. The auditor is required to issue such a report on the SEFA.

The GAS/SA Audit Guide, Paragraph 13.11, lists the following required elements for the auditor's report on the schedule of expenditures of federal awards based on AU-C 725.09. The report should state that:

a. The audit was conducted for the purpose of forming an opinion on the financial statements as a whole.

b. The schedule of expenditures of federal awards is presented for purposes of additional analysis and is not a required part of the financial statements.

c. The schedule of expenditures of federal awards is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.

d. The schedule of expenditures of federal awards has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves and other additional procedures, in accordance with auditing standards generally accepted in the United States of America.

e. In the auditor's opinion, the schedule of expenditures of federal awards is fairly stated, in all material respects, in relation to the financial statements as a whole.

The GAS/SA Audit Guide, Paragraph 13.13, recommends reporting on the SEFA as supplementary information in the report on the financial statements. However, a separate report may be issued instead. The GAS/SA Audit Guide, Paragraph 13.11, explains that when the SEFA is presented with the financial statements, the auditor should report on the schedule in either (a) an other-matter paragraph in the report on the financial statements or (b) in a separate report on the SEFA. The use of an other-matter paragraph is applicable when the SEFA is reported on in the auditor's report on the financial statements. Otherwise, the reporting on the SEFA may be included in the Uniform Guidance report on compliance and on internal control over compliance or in a separate report.

According to the GAS/SA Audit Guide, Paragraph 13.12 when the SEFA is not presented with the financial statements and the auditor includes the in-relation-to reporting in either the report on compliance and on internal control over compliance or in a separate report, the separate report should include the elements listed in the previous paragraph and (a) a reference to the report on the financial statements, (b) the date of that report, (c) the nature of the auditor's opinion on the financial statements, and (d) any report modifications.

The GAS/SA Audit Guide, Paragraph 13.12, further explains that when the auditor reports on the SEFA in either the report on compliance and on internal control over compliance or in a separate report, the auditor might consider including an alert that restricts the use of the separate report solely to the specified parties.

Qualified Opinion on the Financial Statements. If the auditor issues a qualified opinion on the financial statements and the qualification has an effect on the supplementary information, AU-C 725.09 states that the auditor's report on the supplementary information should include the auditor's opinion that, except for the effects on the

supplementary information of the qualification, such information is fairly stated, in all material respects, in relation to the financial statements as a whole. The statement should include a reference to the paragraph in the auditor's report that explains the qualification. An example of such an other matter paragraph is as follows:

> Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The schedule of expenditures of federal awards is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, except for the effect on the schedule of expenditures of federal awards of [Describe the reason for qualification of the opinion on the financial statements and reference the other-matter paragraph.], the schedule of expenditures of federal awards is fairly stated in all material respects in relation to the financial statements as a whole.

Adverse Opinion or Disclaimer of Opinion on the Financial Statements. If the auditor issues an adverse opinion or a disclaimer of opinion on the financial statements, the auditor is precluded from expressing an in-relation-to opinion on the schedule of expenditures of federal awards. The auditor may withdraw from the engagement when permitted by law or regulation. Unless the auditor chooses to withdraw, AU-C 725.11 requires the report on the supplementary information to include a statement that because of the significance of the matter disclosed in the report, it is inappropriate to, and the auditor does not express an opinion on the supplementary information referred to in the report. Examples of such statements are as follows:

> Adverse opinion: "Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The schedule of expenditures of federal awards is presented for the purposes of additional analysis and is not a required part of the financial statements. Because of the significance of the matter described above [Describe the reason for the adverse opinion.], it is inappropriate to and we do not express an opinion on the schedule of expenditures of federal awards."

> Disclaimer of opinion: "We were engaged for the purpose of forming an opinion on the basic financial statements as a whole. The schedule of expenditures of federal awards is presented for the purposes of additional analysis and is not a required part of the financial statements. Because of the significance of the matter described above [Describe the reason for the disclaimer of opinion.], it is inappropriate to and we do not express an opinion on the schedule of expenditures of federal awards.

Supplementary Information Is Materially Misstated. AU-C 725.13 states that if the auditor concludes that the supplementary information is materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose that the information be revised. If management refuses to revise the supplementary information, the auditor should either (a) modify the opinion on the supplementary information and describe the misstatement in the auditor's report or (b) if a separate report is being issued on the supplementary information, withhold the auditor's report on the supplementary information.

Date of Report. AU-C 725.12 indicates that the date of the auditor's report on the SEFA "should not be earlier than the date" the auditor completed the procedures in AU-C 725.07 required for opining on whether the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Illustrated Reporting. The auditor reports on the schedule of expenditures of federal awards in either (a) an other-matter paragraph following the opinion paragraph in the auditor's report on the financial statements or (b) in a separate report (which may be included in the report on compliance and on internal control over compliance or may be a stand-alone report). The illustrative auditor's reports in the GAS/SA Audit Guide combine the report on the schedule of expenditures of federal awards with the report on the financial statement. The GAS/SA Audit Guide also

illustrates combining the report on the schedule of expenditures of federal awards with the Uniform Guidance report on compliance and internal control over compliance. The GAS/SA Audit Guide does not illustrate a stand-alone report. except in the circumstance where the auditor is engaged to issue an opinion on the schedule of expenditures of federal awards under AU-C 805.

Reporting on the Schedule of Expenditures of Federal Awards under AU-C 805

In order for an auditor to provide an in-relation-to opinion on supplementary information, the auditor issuing the opinion must have audited the financial statements. If the auditor did not audit the financial statements, the auditor is precluded from issuing an in-relation-to opinion on the supplementary information. For example, the auditor may have been engaged to perform only the compliance audit and not the financial statement audit.

To meet reporting requirements of the Uniform Guidance, the auditee may consider engaging the auditor to issue an opinion on the schedule of expenditures of federal awards under AU-C 805, *Special Considerations—Audits of Single Financial Statement and Specific Elements, Accounts, or Items of a Financial Statement*. Paragraph 7.38 of the GAS/SA Audit Guide explains that the auditor's objective when performing the audit of the SEFA under AU-C 805 is to obtain sufficient appropriate audit evidence to enable the auditor to express an opinion on the schedule (which is the single financial statement). The audit should be designed to provide the auditor with reasonable assurance that the SEFA is not misstated by an amount that would be material to the information contained in the SEFA.

Communicating Significant Matters

Auditors need to consider the professional requirements when evaluating significant matters that may arise during the audit of the schedule of expenditures of federal awards.

SELF-STUDY QUIZ

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

14. The GAS/SA Audit Guide, Paragraph 4.54, lists requirements for the auditor's standard report on internal control over financial reporting and compliance. Which of the following would **not** be in the report?

    a. The definition of a material weakness.

    b. A statement that no material weaknesses exist.

    c. A statement that specific deficiencies in internal control over financial reporting were identified that the auditor considers significant.

    d. The auditor's firm signature.

15. Which of the following statements concerning the contents of the schedule of expenditures of federal awards is true?

    a. The notes describing the significant accounting policies used in preparing the SEFA should be included in the notes to the financial statements.

    b. The schedule period should be different from the period covered by the financial statements.

    c. Amount provided to subrecipients.

    d. Federal awards expended for each program should be included in the schedule, but only if material.

16. Which of the following is considered optional information for the schedule of expenditures of federal awards?

    a. Nonfederal expenditures.

    b. CFDA or identifying number.

    c. Federal awards expended for research and development clusters.

    d. A note describing significant accounting policies used.

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. The GAS/SA Audit Guide, Paragraph 4.54, lists requirements for the auditor's standard report on internal control over financial reporting and compliance. Which of the following would **not** be in the report? **(Page 71)**

    a. The definition of a material weakness. [This answer is incorrect. The 2007 Yellow Book requires auditors to include the definitions of significant deficiency, deficiency in internal control, and material weakness in the standard report on internal control over financial reporting and compliance.]

    b. A statement that no material weaknesses exist. [This answer is correct. 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. However, material weaknesses may exist that were not identified. Therefore, the auditor cannot state that no material weaknesses exist.]

    c. A statement that specific deficiencies in internal control over financial reporting were identified that the auditor considers significant. [This answer is incorrect. If significant deficiencies were identified, the report would include 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.]

    d. The auditor's firm signature. [This answer is incorrect. The signature of the auditor's firm is included in the standard report on internal control over financial reporting and compliance.]

15. Which of the following statements concerning the contents of the schedule of expenditures of federal awards is true? **(Page 79)**

    a. The notes describing the significant accounting policies used in preparing the SEFA should be included in the notes to the financial statements. [This answer is incorrect. Note(s) describing the significant accounting policies used in preparing the SEFA are separate from the notes to the financial statements.]

    b. The schedule period should be different from the period covered by the financial statements. [This answer is incorrect. The period covered by the schedule must be the same as that covered by the financial statements.]

    c. Amount provided to subrecipients. [This answer is correct. Total amount provided to subrecipients from each federal program.]

    d. Federal awards expended during the period for each program should be included in the schedule, but only if material. [This answer is incorrect. The report includes the total federal awards expended during the period for each individual federal program whether or not the amount is material.]

16. Which of the following is considered optional information for the schedule of expenditures of federal awards? **(Page 82)**

    a. Nonfederal expenditures. [This answer is correct. While its inclusion is not required by federal guidelines, nonfederal information, including nonfederal expenditures, may be included in the schedule. According to Paragraph 7.27 of the GAS/SA Audit Guide, when nonfederal information is included, the federal and nonfederal information is required to be presented separately and appropriately labeled.]

    b. CFDA or identifying number. [This answer is incorrect. The CFDA numbers, or other identifying number when a CFDA number is not available, is a minimum requirement for a schedule according to 2 CFR section 200.510(b).]

    c. Federal awards expended for research and development clusters. [This answer is incorrect. For research and development clusters, federal awards expended either by individual award or by federal agency and major subdivision within the agency must be included on the schedule.]

    d. A note describing significant accounting policies used. [This answer is incorrect. A note to describe the significant accounting policies used in preparing the schedule is a required element.]

REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY THE UNIFORM GUIDANCE

As indicated at Exhibit 2-1 and Exhibit 2-2, an audit performed in accordance with the Uniform Guidance (single audit) includes reporting on compliance and on internal control over compliance in addition to the reporting required by the Yellow Book. The illustrative auditor's reports included in the GAS/SA Audit Guide combine the reporting on compliance and on internal control over compliance required by the Uniform Guidance into a single report. However, representatives of OMB have recommended that the Uniform Guidance report not be combined with the Yellow Book report.

Reporting Guidance in AU-C 935, *Compliance Audits*

AU-C 935, *Compliance Audits*, applies when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with all of the following: GAAS, *Government Auditing Standards* requirements for financial audits, and a governmental audit requirement (such as the Uniform Guidance) that requires the auditor to express an opinion on compliance. AU-C 935 provides guidance on adapting and applying GAAS in a compliance audit. Accordingly, it provides enhanced reporting guidance for auditors engaged in compliance audits by—

- Identifying the elements to be included in the auditor's report in a compliance audit.
- Discussing conditions that would result in a modified report and addressing certain other reporting issues.
- Providing an example of a combined report on compliance and internal control over compliance.

AU-C 935.10, explicitly states that the auditor's objectives in a compliance audit include (a) identifying audit and reporting requirements that are in addition to those contained in GAAS and the Yellow Book and (b) obtaining sufficient audit evidence to form an opinion and report at the specified level on the entity's compliance in all material respects with the applicable compliance requirements. As indicated in Exhibit 2-1 and Exhibit 2-2, the Uniform Guidance at 2 CFR section 200.515 requires reports on the following:

- The schedule of expenditures of federal awards in relation to the financial statements.
- Internal control over financial reporting and compliance with provisions of laws, regulations, contracts, and award agreements, noncompliance with which could have a material effect on the financial statements.
- Compliance with federal statutes, regulations, and the terms and conditions of federal awards at the major program level.
- Internal control over compliance with laws, regulations, contracts, and grant requirements at the major program level.
- Internal control over compliance with federal statutes, regulations, and the terms and conditions of federal awards.

The auditor is permitted to choose whether to issue a combined report on compliance and internal control over compliance or to issue two separate reports—a report on compliance and a report on internal control over compliance. The Uniform Guidance similarly allows the auditor the option of issuing either separate or combined reports. However, the GAS/SA Audit Guide recommends combining the report on compliance with the report on internal control over compliance in a single audit.

Required Elements. The GAS/SA Audit Guide, Paragraph 13.26, states that the auditor's report on compliance and internal control over compliance should include the following basic elements:

- A title that includes the word *independent*.
- An addressee that is appropriate for the engagement.

- A section with the heading "Report on Compliance for Each Major Federal Program."
- An introductory paragraph that includes the following:
  - A statement that the auditor has audited the entity's compliance with the types of compliance requirements described in the OMB Compliance Supplement that could have a direct and material effect on each of its major federal programs.
  - A statement that the major federal programs are identified in the summary of the auditor's results section of the accompanying schedule of findings and questioned costs.
  - The period covered by the report.
- The subheading "Management's Responsibility," followed by a statement that compliance with the requirements of federal statutes, regulations, and the terms and conditions of federal awards is the responsibility of the entity's management.
- The subheading "Auditor's Responsibility," followed by statements that:
  - The auditor's responsibility is to express an opinion on compliance for each of the major federal programs based on the audit of the types of compliance requirements.
  - The compliance audit was conducted in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and the audit requirements of Title 2 US. CFR Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*.
  - Those standards and the Uniform Guidance require that the auditor plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements that could have a direct and material effect on a major federal program occurred.
  - An audit includes examining, on a test basis, evidence about the entity's compliance with those requirements and performing such other procedures as the auditor considered necessary in the circumstances.
  - The auditor believes the compliance audit provides a reasonable basis for the auditor's opinion.
  - The compliance audit does not provide a legal determination of the entity's compliance with those requirements.
- If the auditor's opinion on all major programs is unmodified, the subheading "Opinion on Each Major Federal Program," followed by a statement that, in the auditor's opinion, the entity complied, in all material respects, with the types of compliance requirements that could have a direct and material effect on each of its major federal programs for the year ended [Date].
- If noncompliance for a major program results in a qualified opinion, the subheading "Basis for Qualified Opinion on [Name of Major Federal Program]," followed by statements that:
  - As described in the accompanying schedule of findings and questioned costs, the entity did not comply with requirements regarding [Identify the types of compliance requirements, related major program, and reference number(s) of the finding(s).].
  - Compliance with such requirements is necessary, in the auditor's opinion, for the entity to comply with the requirements applicable to the program(s).
- If noncompliance results in a qualified opinion for one or more major programs, an appropriate subheading (for example, "Qualified Opinion on [Name of Major Federal Program]") that includes the auditor's

opinion on whether the entity complied, in all material respects, with the types of compliance requirements that could have a direct and material effect on each of its major federal programs. [If the opinions on other major programs are not qualified, the subheading for the opinion paragraph relating to the unmodified opinion(s) might be worded "Unmodified Opinion on Each of the Other Major Federal Programs" to point out more clearly the programs with unqualified opinions.]

- If other noncompliance does not result in a modified opinion but is required to be reported in accordance with the Uniform Guidance, the subheading "Other Matters," followed by:
  - A reference to the schedule of findings and questioned costs in which the noncompliance is described, including the reference number(s) of the finding(s).
  - A statement that the auditor's opinion on each major federal program is not modified with respect to the matters.
  - A statement that the entity's response to the noncompliance findings is described in the accompanying schedule of findings and questioned costs and/or corrective action plan.
  - A statement that the entity's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, the auditor expresses no opinion on the response.
- The section "Report on Internal Control Over Compliance" that includes the following statements and definitions:
  - A statement that management is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements.
  - A statement that in planning and performing the compliance audit, the auditor considered the entity's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major program, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance.
  - A statement that the auditor is not expressing an opinion on the effectiveness of internal control over compliance.
  - The definitions of *deficiency in internal control over compliance*, *material weakness in internal control over compliance*, and *significant deficiency in internal control over compliance*. A note to the GAS/SA Audit Guide, Paragraph 13.26k(iv), clarifies that the definition of *significant deficiency in internal control over compliance* is not required to be included in the report when no such deficiencies were identified. However, the definitions of *deficiency in internal control over compliance* and *material weakness in internal control over compliance* must be included in the report.
  - A statement that the auditor's consideration of internal control over compliance was for the limited purpose described in the first paragraph of the section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies.
  - If no material weaknesses were identified, a statement that the auditor did not identify any deficiencies in internal control over compliance that are considered to be material weaknesses.
  - A statement that material weaknesses may exist that have not been identified. (If significant deficiencies or material weaknesses are identified, this would state that material weaknesses or significant deficiencies may exist that have not been identified.)
  - If significant deficiencies were identified, a statement that no deficiencies in internal control over compliance were identified that are considered to be material weaknesses; however, deficiencies in internal control over compliance were identified that are considered to be significant deficiencies, and

a description of the significant deficiencies or a reference to the accompanying schedule of findings and questioned costs, including the reference number(s) of the finding(s).

- If material weaknesses were identified, a statement that deficiencies in internal control over compliance were identified that are considered to be material weaknesses, and a description of the material weaknesses or a reference to the accompanying schedule of findings and questioned costs, including the reference number(s) of the finding(s).

- If applicable, a statement that the entity's response to the internal control findings is described in the accompanying schedule of findings and questioned costs and/or corrective action plan.

- If applicable, a statement that the auditee's response to the internal control findings identified in the audit was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, the auditor expresses no opinion on the response. A note to the GAS/SA Audit Guide, Paragraph 13.26k(xi), clarifies that while AU-C 935.A36 indicates that the auditor may add this statement to the report, its inclusion is not required.

- A separate paragraph at the end of the section stating that the purpose of the report on internal control over compliance is solely to describe the scope of the auditor's testing of internal control over compliance and the result of that testing based on the requirements of the Uniform Guidance, and that accordingly, the report is not suitable for any other purpose.

- The manual or printed signature of the auditor's firm.

- The auditor's city and state.

- The date of the auditor's report.

Purpose Alert Paragraph—Uniform Guidance Reports on Compliance and Internal Control over Compliance

AU-C 905, *Alert That Restricts the Use of the Auditor's Written Communication*, provides guidance on including in the auditor's report a paragraph that either restricts the use of the auditor's report or describes the purpose of the auditor's report or other written communication. The "restricted use alert" or "purpose alert" is included in an other-matter paragraph in the report. According to AU-C 905.11, a purpose alert is used when (a) the engagement is performed in accordance with *Government Auditing Standards* and (b) the auditor's written communication pursuant to that engagement is issued in accordance with any of the following:

- AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.

- AU-C 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements*.

- AU-C 935, *Compliance Audits*.

The GAS/SA Audit Guide, Paragraph 13.26, footnote 26, explains that, in a single audit, the auditor's report on compliance and internal control over compliance should include an other-matter paragraph that describes the purpose of the auditor's report and states that the report is not suitable for any other purpose. However, in combined reports on compliance and internal control over compliance, the purpose alert should only be included in the internal control over compliance section because it is the nature of the reporting on internal control that triggers the required use of the alert. (If the auditor issues separate reports on an entity's compliance and on its internal control over compliance, the purpose alert should be included in the report on internal control over compliance, but would not be in the report on compliance.)

Reporting on Compliance with Major Program Requirements

The previous paragraph describes the elements that are required to be included in the auditor's report on compliance, including the auditor's opinion on whether the entity complied, in all material respects, with applicable

compliance requirements. The Uniform Guidance specifies that, in a single audit, auditors are to test major program compliance with federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on its major programs. The testing should be adequate to support an opinion on such compliance.

Material Effect. AU-C 935.29 states that noncompliance and other matters that are required to be reported by the governmental audit requirement should be reported in the manner specified by the requirement. In forming an opinion, the auditor should evaluate (a) known and likely questioned costs and (b) other material noncompliance that, typically, might not be associated with questioned costs.

When reporting on major program compliance in a single audit, the objective is to express an opinion on whether the governmental unit or nonprofit organization complied, in all material respects, with the requirements of federal statutes, regulations, and the terms and conditions of federal awards that, if noncompliance occurred, *may* have a direct and material effect on a major program. (For clusters, materiality is based upon the cluster rather than the individual programs within the cluster.) The phrase "direct and material effect," when the auditor has identified questioned costs, 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. Noncompliance with a reporting requirement also could have a material effect on a major program if it resulted in cancellation of an award, even though this type of noncompliance typically does not result in questioned costs.

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 grants, disallow charges, or demand refunds. However, the Uniform Guidance 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 10.10 of the GAS/SA Audit Guide indicates that materiality in a compliance audit performed under the Uniform Guidance 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.

Paragraph 10.12 of the GAS/SA 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 4.47, 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.

The application and other explanatory material at AU-C 935.A31 lists the following factors that the auditor may consider in evaluating the sufficiency and appropriateness of the audit evidence to determine whether the governmental unit or nonprofit organization has materially complied with applicable compliance requirements:

a. The frequency of noncompliance identified in the compliance audit.

b. The nature of the noncompliance.

c. The adequacy of the entity's system for monitoring compliance and the possible effect of any noncompliance.

d. Whether any instances of noncompliance identified result in likely questioned costs that are material to the program.

Paragraph 10.60 of the GAS/SA 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)." As discussed in Paragraph 11.118 of the GAS/SA Audit Guide, if the auditor used sampling for the compliance test, it may be necessary to project the sample results to determine both known questioned costs and estimate likely questioned costs in order to assess the effect of noncompliance on the auditor's opinion on compliance and whether an audit finding has to be reported.

Best practices suggest 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*, the Uniform Guidance requires additional reporting on internal control. The additional matters relate to controls relevant to major federal *programs*. Paragraph 9.10 of the GAS/SA 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. 2 CFR section 200.514(c)(3) and Paragraph 9.08 of the GAS/SA Audit Guide indicate the auditor must plan the testing of internal control over compliance for major programs to support a low assessed level of control risk of noncompliance for the assertions relevant to the compliance requirements for each major program, and perform tests as planned.

The elements that are required by AU-C 935 to be included when the auditor issues a combined report on compliance and internal control over compliance are discussed earlier in this section. The key elements include a statement about the scope of the auditor's consideration of internal control over compliance and a reference, if applicable, to an accompanying schedule that describes the internal control deficiencies that are required to be reported. The Uniform Guidance specifies that internal control matters that are required to be reported in a single audit are reported in the schedule of findings and questioned costs.

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. AU-C 935.34–.35 provides guidance for modifying the auditor's report on compliance. The auditor should modify the report using the guidance in AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, if material noncompliance is identified in the audit, or if there is a restriction on the scope of the single audit. AU-C 935.30 states that the report should include an appropriately-headed section that indicates the basis for the modified opinion and either describes the noncompliance or refers to an accompanying schedule

where the noncompliance is described. Under AU-C 935, other noncompliance that is required to be reported by the governmental audit requirement but that does not result in an opinion modification should also be described, or the report should include a reference to an accompanying schedule where it is described.

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.

Reports on Departments, Agencies, Component Units, and Other Organizational Units

The guidance listed earlier for modifying the Yellow Book report on internal control over financial reporting also applies to the Uniform Guidance report on compliance and on internal control over compliance.

Reporting When Audit of Federal Awards Does Not Include All of the Auditee's Operations That Expend Federal Awards

As discussed, and in Paragraph 13.32 of the GAS/SA 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 basic financial statements include the operations of the [*Identify Component Unit, Operating Unit or Department*.] , which received [*dollar amount*] in federal awards which is not included in Name of Governmental Unit or Nonprofit Organization's the schedule if expenditures of federal awards 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 an audit of compliance*.] .

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, 2 CFR section 200.511(a) 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.

The summary schedule must include the reference numbers discussed later in this lesson. Since the summary schedule may include audit findings from multiple years, the fiscal year in which the finding initially occurred must also be included, for example 20X1-003 or 20X2-006. (See Exhibit 2-6.)

Illustrated Schedule

An illustrated summary schedule of prior audit findings is provided at Exhibit 2-6. Other formats may be equally acceptable.

Exhibit 2-6

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 20X2-001:[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 20X2-002: 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 20X1-004: 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. HUD has not responded to the waiver request.

FINDING 20X1-005: Head Start Program. The discussion for Finding 20X2-001 also applies to this Finding.

Notes:

[a] Under the Uniform Guidance all audit findings, even those relative to the Yellow Book must be included.

[b] The Uniform Guidance requires that the summary schedule "list the audit findings." Best practices indicate that 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] 20X2-001 refers to the year and the finding number; for example 2012-001 or 12-001.

[d] There is no specific requirement to indicate that no similar findings were noted in the current audit; however, best practices indicate that 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. The summary schedule must also include 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 10.66 and 10.67 of the GAS/SA 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 must describe the reason for the recurring finding and 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 must 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 must 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 FAC;

   (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.

e. The schedule must include Yellow Book findings related to the financial statements (unless the finding may be excluded as discussed in a. or d. above).

Paragraph 13.49 of the GAS/SA Audit Guide indicates that if there were no prior findings, the auditee is not required to prepare a summary schedule. Federal agencies and other interested parties can use the FAC database to determine that the requirements of the Uniform Guidance were met.

SELF-STUDY QUIZ

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

17. When reporting on requirements with major program requirements, which of the following statements are true regarding the materiality of findings?

    a. A noncompliance finding related to a new program or changes in procedures for an existing program is more likely to be a material finding.

    b. 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.

    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.

18. When does the auditee **not** have to provide an explanation or a description on the summary schedule of prior audit findings?

    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.

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. When reporting on requirements with major program requirements, which of the following statements is true regarding the materiality of findings? **(Page 99)**

    a. 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.]

    b. Most often a small number of small noncompliance items of a small questioned cost that is likely to be an isolated incident is 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.]

    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.]

18. When does the auditee **not** have to provide an explanation or a description on the summary schedule of prior audit findings? **(Page 101)**

    a. When audit findings have been fully corrected. [This answer is correct. 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 must describe the reason for the recurring finding and 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 incorrect. The summary schedule must 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 according to GAS/SA Audit Guide.]

    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 must be described in the summary schedule.]

REPORTS ON FRAUD, NONCOMPLIANCE, AND OTHER MATTERS

In evaluating and reporting findings in a single audit, auditors should distinguish among fraud, noncompliance, 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 Uniform Guidance reporting should be reported in accordance with the requirements of the Uniform Guidance. Auditors should use professional judgment to determine the appropriate additional reporting of findings that are included in the Uniform Guidance 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 Uniform Guidance 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 Uniform Guidance Reporting.* Fraud, noncompliance, and abuse that do not involve federal awards or Uniform Guidance reporting but have a material effect on the financial statements should be included in the Yellow Book report on internal control over financial reporting and compliance and other matters.

GAAS Requirements for Reporting Fraud and Noncompliance

Fraud and Noncompliance. Lesson 1 discusses the auditor's responsibility to evaluate the results of audit procedures and consider whether they lead the auditor to believe that fraud may have occurred. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, discusses the auditor's detection responsibilities related to misstatements caused by fraud. AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, imposes detection and communication responsibilities for violations of laws and regulations, including when and with whom they are communicated, that have a *direct and material effect* on the determination of financial statement amounts. AU-C 250 imposes lesser responsibilities for detection of violations of laws or regulations having *material but indirect* effects on the determination of financial statement amounts (primarily inquiry and inspection of any relevant correspondence) and establishes communication responsibilities for those violations.

Under AU-C 250 and AU-C 240, the auditor ordinarily is not responsible for disclosing fraud or violations of laws and regulations to parties other than senior management and those charged with governance; however, both specifically recognize the auditor's duty to disclose such matters to a funding agency or other specified agency in accordance with governmental audit requirements; e.g., in a single audit or a financial audit made in accordance with the GAO's *Government Auditing Standards*. Also, state laws may require communication of certain fraud or violations of laws or regulations. Some states provide criminal penalties for those who fail to report a felony to the proper authorities. Others require auditors to maintain confidentiality. Best practices suggest that auditors seek legal advice in those situations.

AU-C 250.21 requires that the auditor be sure the audit committee or others charged with governance are adequately informed about any violations of laws or regulations, unless clearly inconsequential, that come to the auditor's attention. If the auditor determines there is evidence fraud may exist (even if the matter is inconsequential), the auditor is required 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. AU-C 240.A69 indicates that auditors *may consider it appropriate* to communicate with those charged with governance about misappropriations committed by lower-level employees that do not result in a material misstatement. Auditors also normally reach an understanding with those charged with governance regarding communication about those misappropriations committed by lower-level employees. In the absence of such an agreement, best practices indicate that the auditor needs to report all instances of fraud to both the appropriate level of management and to those charged with governance. Best practices suggest that communications about possible fraud be made in writing; if made orally, the nature of the communication should be documented in the workpapers.

In some cases, the auditor may have a duty to disclose fraud or violations of laws or regulations to parties outside of the entity. Examples of those situations include:

- To comply with legal or regulatory requirements.
- To a successor auditor making inquiries in accordance with AU-C 210, *Terms of Engagement*.
- When responding to a subpoena.
- To a government funding agency or other specified agency when complying with requirements for audits of recipients of governmental financial assistance.

Before disclosing instances of fraud to parties outside the entity, best practices suggest the auditor consult with legal counsel due to the nature of the auditor's ethical and legal obligations.

Government Auditing Standards Requirements

The auditor's responsibilities under GAAS for determining whether those charged with governance are adequately informed about fraud and violations of laws and regulations is discussed earlier. The Yellow Book expands this to include abuse and noncompliance with provisions of contracts and grant agreements.

The Yellow Book requires the auditor to provide written communication about findings of noncompliance or abuse "that are less than material but warrant the attention of those charged with governance." The Yellow Book, at Paragraph 4.26, leaves to the auditor's judgment whether and how to communicate findings that do not warrant the attention of those charged with governance. Best practices suggest that these be communicated in a management letter.

Fraud and Noncompliance. Under *Government Auditing Standards*, the auditor's responsibility for reporting fraud or instances of noncompliance 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.

Consult with an Attorney. It is strongly recommend that the auditor consult with an attorney on whether a reportable act has occurred and on the wording of the report on fraud, noncompliance, 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 section, 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. (GAAS 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. In addition, the Uniform Guidance requires communication of abuse relating to major programs.

Abuse Relating to Federal Awards. The Yellow Book standards relating to abuse apply to all aspects of a single audit engagement, including the compliance audit portion. However, abuse does not necessarily involve fraud or noncompliance. The Yellow Book, at Paragraph 4.07, 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.

Paragraphs 10.48 and 13.40 of the GAS/SA 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 detect 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. 2 CFR section 200.516(a)(1) states that significant instances of abuse related to a major program must be reported as audit findings in the schedule of findings and questioned costs. Such findings of abuse would be reported in the federal awards section of the schedule of findings and questioned costs. If the abuse is material to the financial statements, the finding should be reported in the Yellow Book report and must be presented in the financial statement section of the schedule of findings and questioned costs. If abuse relates to both the financial statements and federal awards, it must be reported in both sections, although one may be summarized.

COMMUNICATING CONTROL DEFICIENCIES AND OTHER COMMENTS

In a single audit, the auditor has certain reporting and communication responsibilities under *Government Auditing Standards* and the Uniform Guidance with respect to control deficiencies. The professional standards under GAAS provide the terminology and definitions the auditor uses for evaluating internal control matters to comply with the reporting requirements. This section summarizes that guidance.

Control Deficiencies

Although *Government Auditing Standards* do not require an auditor to perform procedures specifically to identify deficiencies in internal controls, the auditor should communicate certain control deficiencies when they are identified during the audit. For purposes of reporting on internal control over financial reporting, AU-C 265.07 states that a control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions to prevent, or detect and correct, misstatements on a timely basis.

For single audits, the auditor should also evaluate internal control matters in relation to major federal award programs. 2 CFR section 200.516(a) requires that all significant deficiencies and material weaknesses in internal control over major programs be reported in the schedule of findings and questioned costs. AU-C 935.11 builds upon the AU-C 265.07 definition of a deficiency in internal control provided earlier in this lesson by stating it in the context of *internal control over compliance*.

The auditor should evaluate the severity of each control deficiency identified during the audit to determine whether it is, individually or in combination, a significant deficiency or a material weakness. AU-C 265.09 states that the auditor should evaluate each deficiency to determine, on the basis of the audit work performed, whether, individually or in combination, it is a significant deficiency or material weakness. Auditors should evaluate control deficiencies individually and in combination with other deficiencies affecting the same significant account balance or disclosure, relevant assertion, or component of internal control because multiple control deficiencies increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness even though they are individually insignificant.

In a single audit, a control deficiency, or combination of deficiencies, in internal control over compliance is a *material weakness* if there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis. A control deficiency, or combination of deficiencies, is a *significant deficiency* when it is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance. For the single audit, materiality is measured in relation to a type of compliance requirement for a major program.

Control deficiencies, noncompliance, 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 Yellow Book, beginning at Paragraph 4.11, describes these elements as criteria, condition, cause, and effect or potential effect.

In addition to the overall standards for reporting internal control deficiencies, the Yellow Book provides a specific reporting threshold for fraud and noncompliance.

Interim Communication of Deficiencies in Internal Control over Compliance

OMB guidance has encouraged auditors to promptly inform the entity's management and those charged with governance of identified deficiencies in internal control over compliance related to Recovery Act awards that were, or were likely to be, significant deficiencies or material weaknesses. The purpose of the early communication during the audit engagement was to allow management to take corrective action as quickly as possible and mitigate the risk of improper award expenditures. In response to these developments, the AICPA issued three Auditing Interpretations to provide guidance for auditors that desire to make interim written communications about internal control matters.

The Auditing Interpretations at AU-C 9265.01–.10 confirm that the auditor may provide an interim written communication of deficiencies in internal control over compliance to management and those charged with governance. However, because of the potential for misinterpretation, it is *not* appropriate to issue an interim communication that states no significant deficiencies or material weaknesses were identified as of the interim date. The Interpretations provide illustrative language that may be used when the auditor chooses to provide an early written communication of significant deficiencies or material weaknesses in internal control over compliance.

Communicating Other Findings to Management

Management letters (or another form of written communication) may 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, noncompliance with provisions of contracts and grant agreements, and abuse that has an effect on the financial statements that is less than material but warrants the attention of those charged with governance, should be communicated in writing to officials of the audited entity. The GAS/SA Audit Guide, Paragraph 4.72, states that this may be done in what is commonly referred to as a management letter. The Yellow Book leaves to the auditor's judgment whether and how to communicate findings of fraud, noncompliance, or abuse that do not warrant the attention of those charged with governance. Best practices suggest that these also be communicated in a management letter; however, the discussion of these matters ought to be worded such that they are distinguished from matters for which written communication is required.

Neither GAAS 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/SA Audit Guide, at Paragraph 4.73, 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.

The schedule of findings and questioned costs must include all audit findings required to be reported under the Uniform Guidance. A separate written communication (such as a management letter) may not be used to communicate such matters. However, matters that do not rise to the Uniform Guidance reporting requirement level but that, in the auditor's judgment, warrant the attention of those charged with governance should be communicated either orally or in a written communication. There is no requirement for such a written communication to be referred to in the Uniform Guidance report.

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. Best practices indicate that the written form of communication is preferable. Written communications may make a stronger impression on the client because they are more formal than a casual discussion. Management may route applicable portions of the communication to other personnel involved in the areas addressed. Also, a written communication 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 best practices indicate that 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, best practices suggest 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.

Best practices indicate that the relevant aspects of a management letter include:

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 *Government Auditing Standards* required written communication of noncompliance with provisions of contract and grant agreements, and abuse, that has an effect on the financial statements or other financial data significant to the audit objectives that is less than material but warrants the attention of those charged with governance.

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. When audit organizations are subject to public records laws, Paragraph 4.44 of the Yellow Book states that auditors should determine whether public records laws could impact the availability of classified or limited use reports and whether other means of communicating with management and those charged with governance would be more appropriate.

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 is true regarding abuse?

    a. Auditors are not required to detect abuse relating to federal awards.

    b. The Yellow Book standards relating to abuse apply to all aspects of a single audit engagement, except the compliance audit portion.

    c. If abuse is material to the financial statements, the finding generally is reported in the federal awards section of the schedule of findings and questioned costs and reported in the Yellow Book report.

20. Management letters may be used to communicate matters that are not required to be included in the auditor's reports. This course lists some best practices for management letters. Which of the following is **not** recommended?

    a. Auditor A dates the management letter the same date as the auditor's report on the financial statements.

    b. Auditor B uses management letters to communicate findings that the Uniform Guidance requires to be reported in the schedule of findings and questioned costs.

    c. Auditor C states that these matters will be reviewed the following year.

    d. Auditor D includes a summarization of specific immaterial matters that were noted during 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.)**

19. Which of the following statements is true regarding abuse? **(Page 106)**

    a. Auditors are not required to detect abuse relating to federal awards. [This answer is correct. The determination of abuse is subjective; therefore auditors are not required to detect 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.]

    b. The Yellow Book standards relating to abuse apply to all aspects of a single audit engagement, except the compliance audit portion. [This answer is incorrect. The Yellow Book standards relating to abuse apply to all aspects of a single audit engagement, including the compliance audit portion. However, abuse does not necessarily involve fraud or noncompliance.]

    c. If abuse is material to the financial statements, the finding generally is reported in the federal awards section of the schedule of findings and questioned costs and reported in the Yellow Book report. [This answer is incorrect. When abuse that involves federal awards occurs and is material to a major program, it must be reported as audit findings in the schedule of findings and questioned costs. Such findings of abuse would be reported in the federal awards section of the schedule of findings and questioned costs. 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 reported in the Yellow Book report.]

20. Management letters may be used to communicate matters that are not required to be included in the auditor's reports. This course lists some best practices for management letters. Which of the following is **not** recommended? **(Page 108)**

    a. Auditor A dates the management letter the same 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. Auditor B uses management letters to communicate findings that the Uniform Guidance requires to be reported in the schedule of findings and questioned costs. [This answer is correct. Auditors are precluded from using management letters to communicate any findings that Uniform Guidance requires to be reported in the schedule of findings and questioned costs as stated in the GAS/SA Audit Guide.]

    c. Auditor C states that these matters will 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.]

    d. Auditor D includes a summarization of specific immaterial matters that were noted during the audit. [This answer is incorrect. Including a statement that during the audit certain immaterial matters were noted, and that these matters are summarized in this letter is a best practice listed in this course. Some auditors prefer to include the comments in a separate memorandum.]

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

2 CFR section 200.516 requires the auditor to report all findings meeting specified criteria in a schedule of findings and questioned costs (SFQC). Findings include significant deficiencies, material weaknesses, significant instances of abuse, material instances of noncompliance, known questioned costs exceeding $25,000, 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 or material weaknesses.

What Is Included in the Schedule of Findings and Questioned Costs?

The GAS/SA Guide (at Paragraphs 13.33–.34) and 2 CFR section 200.515(d) require inclusion of a schedule of findings and questioned costs in the reporting package and state that the schedule must include the following:

a. A summary of the auditor's results including:

   (1) The type of report the auditor issued on whether the audited financial statements were prepared in accordance with GAAP (i.e., unmodified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).

   (2) Where applicable, a statement that significant deficiencies or material weaknesses in internal control were disclosed by the audit of the financial statements.

   (3) A statement as to whether the audit disclosed any noncompliance that is material to the financial statements.

   (4) Where applicable, a statement that significant deficiencies or material weaknesses in internal control over major programs were disclosed by the audit.

   (5) The type of report the auditor issued on compliance for each major program (i.e., unmodified 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 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 award or 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 the financial statements that are required to be reported in accordance with *Government Auditing Standards*.

c. Findings and questioned costs for federal award programs, which must include audit findings as defined by the Uniform Guidance [2 CFR 200.513(a)]. This section must:

   (1) Present audit findings (e.g., internal control findings, compliance findings, questioned costs, fraud, or abuse) 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. 2 CFR section 200.515(d)(2) requires the SFQC to include a section that reports findings relating to the financial statements. As indicated at Paragraph 13.36 of the GAS/SA Audit Guide, the section of the schedule of findings and questioned costs that details findings related to the financial statements should include all findings related to the financial statement audit that are required to be reported by GAAS and *Government Auditing Standards* in an audit performed under the Uniform Guidance. The Yellow Book, Paragraph 4.23, states that auditors should communicate the following findings in the Yellow Book report on internal control over financial reporting and on compliance and other matters:

- Significant deficiencies and material weaknesses in internal control over financial reporting.
- Instances of fraud and noncompliance with provisions of laws or regulations that have a material effect on the audit and any other instances that warrant the attention of those charged with governance.
- Noncompliance with provisions of contracts and grant agreements that has a material effect on the audit.
- Abuse that has a material effect on the audit. Reporting findings of abuse is also discussed in Paragraph 13.40 of the GAS/SA Audit Guide.)

Findings Relating to Both the Financial Statements and Federal Awards. Audit findings that relate to both the financial statements and federal awards must 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 section of the schedule may be in summary form with a reference to a detailed reporting in the other section of the schedule.

Findings

The GAS/SA Audit Guide, at Paragraph 13.38, and 2 CFR section 200.516(a) indicate that the following must be reported as findings in the federal awards section of the SFQC.

a. *Significant Deficiencies and Material Weaknesses in Internal Control over Major Programs.* The auditor's determination of whether a deficiency in internal control is a significant deficiency or material weakness for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program in the Compliance Supplement.

b. *Material Noncompliance with Federal Statutes, Regulations, or the Terms and Conditions of Federal Awards Related to a Major Program.* The auditor's determination of whether an instance of noncompliance with federal statutes, regulations, contracts, or terms and conditions of the federal awards is material for reporting an audit finding is in relation to a type of compliance requirement for a major program identified in the Compliance Supplement.

c. *Known Questioned Costs That Are Greater Than $25,000 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 must also report *known questioned costs when likely questioned costs are greater than $25,000 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 would include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

d. *Known Questioned Costs That Are Greater Than $25,000 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 that 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 $25,000, then the auditor must report this as an audit finding.

e. *The Circumstances Concerning Why the Opinion in the Auditor's Report on Compliance for Major Programs Is Other Than an Unmodified Opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for federal awards (for example, a scope limitation that is not reported as a finding).*

f. *Known or Likely 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.* The Uniform Guidance does not require the auditor to report publicly information which could compromise investigative or legal proceedings or to make an additional report when the auditor confirms that the fraud was reported outside of his reports under the direct reporting requirements of *Government Auditing Standards*.

g. *Significant Instances of Abuse Relating to Major Programs.*

h. *Instances in Which 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.*

Illustrated Comments. There are numerous formats used for reporting significant deficiencies and material weaknesses. The illustrated schedule of findings and questioned costs at Exhibit 2-7 and Exhibit 2-8 presents two examples.

Recovery Act Considerations. Appendix VII of the Compliance Supplement states that the audit finding detail must include explicit identification of applicable Recovery Act programs.

Exhibit 2-7

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 unmodified opinion on whether the financial statements of [Name of Organization] were prepared in accordance with GAAP

2. Two significant deficiencies disclosed during the audit of the financial statements are reported in the [Name of Report] . No material weaknesses are reported.

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] . No material weaknesses are reported.

5. The auditor's report on compliance for the major federal award programs for [Name of Organization] expresses an unmodified opinion on all major federal programs.

6. Audit findings that are required to be reported in accordance with 2 CFR section 200.516(a) are reported in this Schedule.

7. The programs tested as major programs were: [Names and CFDA Nos.] .

8. The threshold used for distinguishing between Type A and B programs was [Amount] .

9. [Name of Organization] was determined to be a low-risk auditee.

FINDINGS—FINANCIAL STATEMENT AUDIT [a]

SIGNIFICANT DEFICIENCIES

20X2-001 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.

Views of Responsible Officials and Planned Corrective Actions: ABC Organization agrees with the finding and the recommended procedures have been implemented.

20X2-002 Not Illustrated.

FINDINGS AND QUESTIONED COSTS—MAJOR FEDERAL AWARD PROGRAMS AUDIT [a, c]

	Questioned Costs
DEPARTMENT OF ENERGY	
20X2-003 Weatherization Assistance for Low-Income Persons—CFDA No. XX.XXX; Grant No. XXXXX; Grant period—Year ended December 31, 20X1	
Significant Deficiency:[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.	
20X2-004 Weatherization Assistance for Low-Income Persons—CFDA No. XX.XXX; Grant No. XXXXX; Grant period—Year ended December 31, 20X1	
Condition: Documentation of verification of low income status could not be located for three selected grants.	
Criteria: Eligibility for the program requires family income below the poverty level.	
Cause: Procedures are in place for supervisory approval of documentation before assistance is authorized but documentation was apparently not filed correctly.	

		Questioned Costs
	Effect: The cost of the assistance may be disallowed.	
	Context: A sample of 46 grants totaling $118,000 was selected for audit from a population of 200 grants totaling $500,000. The test found three grants that were not in compliance with questioned costs totaling $28,000. Our sample was a statistically valid sample.	$ 8,000 [e]
	Recommendation: ABC Organization should again verify the eligibility of the recipients whose documentation could not be located.	
	Views of Responsible Officials and Planned Corrective Actions: 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	$ 8,000
	DEPARTMENT OF HEALTH AND HUMAN SERVICES	
20X2-005	Head Start Program—CFDA No. XX.XXX; Grant No.—XXXXX; Grant period—year ended June 30, 20X2	
	Significant Deficiency: The significant deficiency at Finding 20X2-001 and 20X2-003 also applies to this grant.[d]	
	Total—Department of Health and Human Services	—
	Total	$ 8,000

Notes:

[a] The findings and views of responsible officials included in this illustrated schedule are for illustrative purposes only. Inclusion here is not intended to suggest these conditions would always be considered findings.

[b] 20X2-001 refers to the year and the finding number; for example 2012-001 or 12-001.

[c] These findings are based on actual findings. The continued applicability of the compliance requirements has not been verified.

[d] 2 CFR section 200.515(d)(3)(ii) 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] Item c., the auditor should report known questioned costs when likely questioned costs exceed $10,000. In this example, the likely questioned cost would be $33,898 ($500,000 ÷ $118,000 × $8,000).

* * *

Exhibit 2-8

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] were prepared in accordance with GAAP.[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 unmodified.[c]

6. Audit findings that are required to be reported in accordance with 2 CFR section 200.516(a) are reported in this Schedule.

7. The programs tested as major programs were: [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		
20X2-001[f]	Award 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.	

		Questioned Costs
	Context: A sample of 25 grants totaling $480,000 was selected for audit from a population of 120 grants totaling $2,760,000. The test found one grant that was not in compliance with questioned costs totaling $28,765. Our sample was a statistically valid sample.	$ 28,765
	Auditor's Recommendation: The responsible city official should be reminded of the procedures in place to ensure that HUD approval is obtained.	
	Views of Responsible Officials and Planned Corrective Actions: 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.[g]	
20X2-002	Award 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.	
	Context: A sample of 36 grants totaling $960,000 was selected for audit from a population of 175 grants totaling $4,277,500. The test found two grants that were not in compliance with questioned costs totaling $49,843. Our sample was a statistically valid sample.	49,843
	Auditor's Recommendation: The responsible city official should be reminded of the procedures in place to ensure that HUD approval is obtained.	
	Views of Responsible Officials and Planned Corrective Actions: The city intends to repay HUD for these costs.[g]	
	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		
20X2-003	Award 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.	

		Questioned Costs
	Context: A sample of 30 grants totaling $250,000 was selected for audit from a population of 150 grants totaling $1,250,000. The test found two grants that were not compliance with questioned costs totaling $1,232. Our sample was a statistically valid sample.	$ 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.	
	Views of Responsible Officials and Planned Corrective Actions: The recommended procedures have been established.[g]	
20X2-004	Award 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 the Uniform Guidance Subpart E. 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.	
	Context: 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.	
	Views of Responsible Officials and Planned Corrective Actions: An extension of the agreement has been requested. If not received, the $166,828 will be returned to HUD.[g]	
	Total—Work Incentive Program	168,060
	Total—Department of Health and Human Services	$ 168,060
DEPARTMENT OF TRANSPORTATION		
20X2-005	Urban Mass Transit Administration—CFDA No. XX.XXX, Award 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.	

	Questioned Costs
Context: A test to compare eligible expenses and cash deposits was performed. 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.	
Views of Responsible Officials and Planned Corrective Actions: The City agrees with the finding and the auditor's recommendations have been adopted.[g]	
Total—Department of Transportation	$ 525,387
Total	$ 772,055

Notes:

[a] 2 CFR section 200.515(d)(1)(i) does not require a description of the report qualification.

[b] Best practices indicate, based on 2 CFR section 200.515(d)(1)(ii) and (iv), 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] 2 CFR section 200.515(d)(1)(v) 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. The continued applicability of the compliance requirements has not been verified.

[f] 20X2-001 refers to the year and the finding number; for example, 2002-001 or 02-001.

[g] The Yellow Book requires the auditor's report to include the views of responsible officials concerning the auditor's findings, conclusions, and recommendations, and the entity's planned corrective actions. The Uniform Guidance also requires including the views of responsible officials.

* * *

Audit Findings That Cannot Be Quantified. While many of the criteria for reporting audit findings noted earlier relate to monetary thresholds, auditors may also encounter instances of noncompliance that can not be quantified. This situation is illustrated in Paragraph 10.64 of the GAS/SA Audit Guide by the following example. Assume that a pass-through entity consistently fails to monitor the activities of its subrecipients to make sure that the subaward is used for authorized purposes. Paragraph 10.64 notes that the Uniform Guidance requires the auditor to consider material noncompliance in relation to a type of compliance requirement identified in the Compliance Supplement

(in this case, subrecipient monitoring). In this situation, the pass-through entity's failure to monitor its subrecipients would likely be material in relation to the subrecipient monitoring compliance requirement and should be reported as an audit finding. The auditor would report this audit finding even if the subrecipient actually complied with the terms and conditions of the subaward and met performance goals. The auditor should also consider whether significant deficiencies or material weaknesses in internal control over compliance exist that require reporting, with respect to subrecipient monitoring. (Reporting is likely required when a pass-through entity consistently fails to monitor subrecipients.)

Audit findings that do not involve federal funds (such as violations of state or local laws) generally should not be included in the federal awards section of the schedule of findings and questioned costs. However, 2 CFR section 200.515(d)(1)(ii) and (iii) require the summary of auditor's results section of the schedule of findings and questioned costs to include (1) a statement about whether significant deficiencies or material weaknesses in internal control were disclosed by the audit of the financial statements and (2) a statement as to whether the audit disclosed any noncompliance that is material to the financial statements. In addition, 2 CFR section 200.515(d)(2) requires the summary of auditor's results to include findings relating to the financial statements that are required to be reported in accordance with *Government Auditing Standards*. Some states have adopted their own single audit type requirements and may have other reporting requirements that should be met. Those findings should be reported on a separate schedule or, if included in the schedule of findings and questioned costs, they should be segregated from findings related to federal programs.

Questioned Costs

2 CFR section 200.84 defines questioned cost as a cost that is questioned by the auditor because of an audit finding:

a. Which resulted from a possible violation or a possible violation of a statute, regulation, or the terms and conditions of a federal award, including funds used to match federal funds.

b. Where the costs, at the time of the audit, are not supported by adequate documentation, or

c. Where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take 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. Best practices indicate, however, there may be situations 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 might be reported as questioned costs.

It should be noted that, in most instances, the auditor is unable to determine whether a federal awarding agency or pass-through entity will ultimately disallow a questioned cost. Paragraphs 10.61–.62 of the GAS/SA Audit Guide explain that federal agencies and pass-through entities have considerable discretion in those matters. In addition, most federal agencies have appeal and adjudication procedures for questioned costs. Accordingly, all questioned costs are subject to uncertainty regarding their resolution.

Reporting Noncompliance

General guidance for preparing the SFQC is found in the Yellow Book at Paragraphs 4.10–.14; 2 CFR section 200.516(b); and the GAS/SA Audit Guide at Paragraphs 13.33–.45. A summary of this guidance follows:

a. The schedule must include a summary of all findings as defined earlier in this section. The findings must 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 identification number and year, name of federal agency, and name of the applicable pass-through entity must be included. When information such as the CFDA title and number or federal award identification number is not available, the auditor must provide the best information available to describe the federal award.

c. The SFQC must include the following, where applicable, for each finding:

(1) *Reference Number*—Include a reference number for each audit finding to allow easy referencing of the audit finding during follow-up. The reference number must be in the format required for the data collection form, that is, a four digit audit year, a hyphen, and a three digit sequence number (e.g., 2014-001, 2014-002, etc.).

(2) *Criteria*—Identify the criteria, specific requirement, or desired state or expectation upon which the audit finding is based, including federal statutes, regulations, or the terms and conditions of the federal awards (for example, the specific regulation not complied with). Criteria provide a context for evaluating audit evidence and understanding findings.

(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) *Statement of Cause*—Describe the reason or explanation for the condition or the factors responsible for the difference between the condition and the criteria.

(5) *Possible Asserted 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 should provide sufficient information to enable a determination of the cause and effect relationship in order to facilitate prompt and proper corrective action.

(6) *Questioned Costs*—Identify questioned costs and how they were computed. Known questioned costs must be identified by CFDA number and federal award identification number.

(7) *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, instances identified must be related to the universe and the number of cases examined and be quantified in terms of dollar value. The auditor should report whether the sampling was a statistically valid sample.

(8) *Identification of Repeat Findings*—Identify whether the finding was a repeat of a finding in the immediate prior audit and, if so, the applicable prior year audit finding number(s).

(9) *Recommendations*—Recommend what the entity should do to prevent future occurrences of the deficiency identified in the finding (for example, develop procedures to implement regulations).

(10) *Views of Responsible Officials*—Report management's views and planned corrective actions (or, alternatively, refer to the separate corrective action plan) for findings in 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 protected personally identifiable information (PII).

e. Audit findings (e.g., internal control matters, compliance findings, questioned costs, fraud, or abuse) that relate to the same issue must be presented as a single audit finding. When practical, audit findings should be organized by federal agency or pass-through entity.

Views of Responsible Officials. The Yellow Book, at Paragraph 4.33, 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. (Best practices indicate that inclusion in the schedule of findings and

questioned costs as required by the Uniform Guidance is the equivalent of inclusion in the "auditor's report.") In addition, 2 CFR section 200.516(b)(10) indicates the schedule of findings and questioned costs must include views of the entity's responsible officials. 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.

Paragraph 13.43 of the GAS/SA Audit Guide indicates that in addressing the views of responsible officials in an audit finding, when auditors receive written comments from the responsible officials addressing their views on audit findings, auditors should include in their report a copy of the officials' written comments or a summary of the comments received. In situations where the responsible officials only provides oral comments, auditors should prepare a summary of the oral comments and provide a copy of the summary to the responsible officials to verify the accuracy of the comments. Alternatively, depending on whether the development of the separate auditee-prepared corrective action plan is complete, the auditor may be able to summarize information found in the corrective action plan or refer to the corrective action plan for the information. Auditors should also include in the report an evaluation of the comments, as appropriate. Paragraph 13.43 notes that when such comments "are inconsistent or in conflict with the report's findings, conclusions, or recommendations, and are not, in the auditor's opinion, valid—or when the planned corrective actions do not adequately address the auditor's recommendations—the auditor should state reasons for disagreeing with the comments or planned corrective actions. Conversely, the auditor should modify their report as necessary if they find the comments valid and supported with sufficient, appropriate evidence."

Relationship of Findings to Reports

Specific relationships between the auditor's reports on financial information, compliance with statutes 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 2-7 and Exhibit 2-8 illustrate one method. Paragraph 13.69, Appendix, Example 13-7 of Chapter 13 of the GAS/SA 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 2-7 and Exhibit 2-8, 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 2 CFR section 200.515(d)(1) as a template while selecting/inserting the appropriate answer to each item, as illustrated in Exhibit 2-9. This format may be used with or without numbers at left identifying the applicable subsection within the Uniform Guidance.

Exhibit 2-9

Alternate Format—Summary of Auditor's Results

SUMMARY OF AUDITOR'S RESULTS

Financial Statements

Type of auditor's report issued: [unmodified, qualified, adverse, OR disclaimer]
Internal control over financial reporting:
Material weakness(es) identified? [yes OR no]
Significant deficiencies identified? [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? [yes OR none reported]
Type of auditor's report issued on compliance for major programs:
[unmodified, qualified, adverse, OR disclaimer (indicate type issued for each program)]
Any audit findings disclosed that are required to be reported in accordance with 2 CFR section 200.516(a)?
[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 AU-C 700, the auditor should, 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.

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 4.41 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, privacy, or 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. Paragraph 4.42 of the Yellow Book further explains that, in some instances, it might be appropriate to issue both a publicly available report with the sensitive information excluded and a limited use report. 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 4.43, 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.

Paragraphs 4.84–.85 of the GAS/SA Audit Guide include additional guidance relating to privileged and confidential information in recognition that auditors may need to exclude reporting certain sensitive information from publicly available reports.

Reissuance of Compliance Report

AU-C 935 establishes requirements for circumstances in which an auditor reissues a report on compliance, for example, when:

- A quality control review performed by a governmental agency indicates that the auditor failed to test direct and material compliance requirements.
- It is subsequently learned that the entity had another government program that was required to be tested.

AU-C 935.43 states that a reissued compliance report should include an other-matter paragraph stating that it is replacing a previously issued report, describing the reasons why it is being reissued, and listing any changes from the previous report.

The date of the reissued report depends on whether the auditor performs additional procedures that relate to all of the programs being reported on or just some of them. The GAS/SA Audit Guide, at Paragraph 13.30, explains that if the auditor performs additional procedures for all of the programs, the report date should reflect the date the auditor obtained sufficient appropriate audit evidence for the events that led to the new procedures. However, if additional procedures are performed for just some of the major programs, the report should be dual-dated. The updated report date should reflect the date the auditor obtained sufficient appropriate audit evidence for the affected programs and should reference the major programs for which additional audit procedures were performed.

AU-C 935 explains that reissuing an auditor-prepared document required by a governmental audit requirement that is incorporated by reference in the auditor's report is considered to be reissuance of the report. Thus, if the schedule of findings and questioned costs is reissued, the auditor should follow the requirements in AU-C 935.43.

Report Retention Requirements

2 CFR section 200.51 2(f) requires an auditee to keep one copy of the data collection form described in lesson 1 and one copy of the reporting package described earlier in this lesson on file for three years from the date of submission to the FAC.

Auditors should establish policies and procedures regarding the retention and safe custody of audit documentation. Those 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. GAAS establish a longer period than the Uniform Guidance does for retention of audit documentation. AU-C 230.17 specifically indicates that this period 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 GAAS is applicable in a single audit.

Loss or Destruction of Audit Documentation—Effect on Report

Technical Q&A (Q&A 8345.02) addresses the destruction of audit documentation by fire, flood, or natural disaster. Best practices indicate the guidance also would apply if audit documentation is lost, deleted, or damaged due to other circumstances. The Q&A 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 audit evidence has been obtained to afford a reasonable basis for expressing an opinion on the financial statements and issuing the required reports on compliance. Furthermore, the auditor should consider the guidance and requirements for audit documentation outlined in Lesson 1 when making the decision. Except for very small engagements, best practices indicate that it is unlikely that the auditor will be able to recreate sufficient documentation without reperforming at least some of the procedures.

SELF-STUDY QUIZ

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

21. 2 CFR section 200.515(d)(2) requires the SFQC to include a section that reports findings relating to the financial statements. Which of the following is an example of a finding related only to the financial statements?

    a. Auditor W reports on findings of significant deficiencies and material weaknesses in internal control over financial reporting.

    b. Auditor X includes a report on compliance for each major program.

    c. Auditor Y includes a statement regarding whether the auditee qualifies as a low-risk auditee.

    d. Auditor Z includes a statement identifying the major programs.

22. 2 CFR section 200.515(d)(2) requires the SFQC to include a section that reports findings relating to the financial statements. Which of the following is an example of a finding to be included in the financial statement section?

    a. Auditor 1 includes any instances of noncompliance with contract provisions that materially affected the audit.

    b. Auditor 2 includes a statement that significant deficiencies or material weaknesses were disclosed by the audit of the financial statements.

    c. Auditor 3 includes a statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee.

    d. Auditor 4 includes a dollar threshold that was used to distinguish between Type A and Type B programs.

23. Regarding reporting findings in the federal awards section of the schedule of findings and questioned costs, GAS/SA Audit Guide, at Paragraph 13.38, and 2 CFR section 200.516(a) requires all of the following **except**:

    a. The auditor's determination of whether a deficiency in internal control is significant.

    b. An additional report regarding known fraud affecting a federal award when the fraud was reported outside of the auditor's reports under the direct reporting requirements of *Government Auditing Standards.*

    c. The auditor's determination of whether noncompliance with federal statutes is material related to a major program.

24. Which of the following statements regarding the schedule of findings and questioned costs is most accurate?

    a. The findings should include the CFDA number.

    b. The findings should be organized by materiality.

    c. The findings should include personal information.

    d. The findings must include a brief summary of the auditor's correction action plan.

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. 2 CFR section 200.515(d)(2) requires the SFQC to include a section that reports findings relating to the financial statements. Which of the following is an example of a finding related only to the financial statements? **(Page 114)**

    a. Auditor W reports on findings of significant deficiencies and material weaknesses in internal control over financial reporting. [This answer is correct. All significant deficiencies and material weaknesses in the internal control over financial reporting should be included only in the finding related to the financial statements, as stated in The Yellow Book, Paragraph 4.23.]

    b. Auditor X includes a report on compliance for each major program. [This answer is incorrect. The type of report the auditor issues on compliance for each major program (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion) is required by 2 CFR section 200.515(d) should be included in the scheduled of findings and questioned cost, but not in the findings related to the financial statements.]

    c. Auditor Y includes a statement regarding whether the auditee qualifies as a low-risk auditee. [This answer is incorrect. The information as to whether the auditee qualifies as a low-risk auditee is required by 2 CFR section 200.515(d) should be included in the scheduled of findings and questioned cost, but not in the findings related to the financial statements.]

    d. Auditor Z includes a statement identifying the major programs. [This answer is incorrect. Identification of the major programs is required by 2 CFR section 200.515(d) should be included in the scheduled of findings and questioned cost, but not in the findings related to the financial statements. (The name of the federal program or cluster should be the same as that listed in the schedule of expenditures of federal awards.)]

22. 2 CFR section 200.515(d)(2) requires the SFQC to include a section that reports findings relating to the financial statements. Which of the following is an example of a finding to be included in the financial statement section? **(Page 114)**

    a. Auditor 1 includes any instances of noncompliance with contract provisions that materially affected the audit. [This answer is correct. The financial statement section of the SFQC should include material violations of provisions of contracts and grant agreements as required by 2 CFR section 200.515(d)(2).]

    b. Auditor 2 includes a statement that significant deficiencies or material weaknesses were disclosed by the audit of the financial statements. [This answer is incorrect. A statement that significant deficiencies or material weaknesses in internal control were disclosed by the audit of the financial statements should be included in the SFQC, but not in the financial statement section.]

    c. Auditor 3 includes 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 should be included in the SFQC, but not in the financial statement section.]

    d. Auditor 4 includes a dollar threshold that was used to distinguish between Type A and Type B programs. [This answer is incorrect. The dollar threshold used to distinguish between Type A and Type B programs should be included in the SFQC, but not in the financial statement section.]

23. Regarding reporting findings in the federal awards section of the schedule of findings and questioned costs, GAS/SA Audit Guide, at Paragraph 13.38, and 2 CFR section 200.516(a) requires all of the following **except**: **(Page 114)**

    a. The auditor's determination of 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 or material weakness for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program in the Compliance Supplement. According to the GAS/SA Audit Guide, at Paragraph 13.38, and 2 CFR section 200.516(a), this should be reported in the federal awards section of the SFQC.]

    b. An additional report regarding known fraud affecting a federal award when the fraud was reported outside of the auditor's reports under the direct reporting requirements of *Government Auditing* Standards. [This answer is correct. Auditors would report known fraud affecting a federal award in the federal awards section of the schedule of findings and questioned costs, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for federal awards. The Uniform Guidance 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 Government Auditing Standards.]

    c. The auditor's determination of whether noncompliance with federal statutes is material related to a major program. [This answer is incorrect. The auditor's determination of whether noncompliance with federal statutes, regulations, or terms and conditions of the federal awards is material for reporting an audit finding is in relation to a type of compliance requirement for a major program identified in the Compliance Supplement. According to the GAS/SA Audit Guide, at Paragraph 13.38, and or terms and conditions of the federal awards, this should be reported in the federal awards section of the SFQC.]

24. Which of the following statements regarding the schedule of findings and questioned costs is most accurate? **(Page 122)**

    a. 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 identification number and year, name of federal agency, and name of the applicable pass-through entity must be included as this is the best information to identify the federal award.]

    b. The findings should be organized by materiality. [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.]

    c. The findings should include personal information. [This answer is incorrect. The schedule should not include protected personally identifiable information (PII).]

    d. The findings must include a brief summary of the auditor's correction action plan. [This answer is incorrect. The findings must 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.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Single Audits—Course 1—Concluding the Single Audit and Reporting under the Single Audit (GSATG171)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This 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 the course, 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.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com**/**ogs** 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 of $89 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 email, mail, or fax your completed answer sheet, as described below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products; they can also be scanned for email grading, if desired. 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. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     GSATG171 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with 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 the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three 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 $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked by **September 30, 2018**. CPE credit will be given for examination scores of 70% or higher.

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) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Single Audits—Course 1—Concluding the Single Audit and Reporting under the Single Audit (GSATG171)

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. Which of the following statements regarding management representation letters is true?

   a. If other audit evidence disputes a representation made by management, the auditor should try to remedy the matter by performing audit procedures.

   b. The auditor can rely on most matters included in the representation letter, rather than acquiring audit evidence.

   c. The auditor is responsible for signing the representation letter.

   d. Auditors can refer to AU-C-935 for a list of specific representations that should be obtained.

2. According to the GAS/SA Audit Guide, auditors should consider certain representations with respect to compliance requirements. Which of the following examples is **not** one of the representations pertaining to the schedule of expenditures of federal awards?

   a. Tracy Blue, manager at ABC, takes responsibility for presenting the schedule according to the Uniform Guidance requirements.

   b. Arthur Green, manager at XYZ, disclosed information regarding important interpretations and assumptions underlying the measurement or presentation of the schedule to the auditor.

   c. Nancy Black, manager at UVW, provided the auditor with interpretations of any compliance requirements that have varying interpretations.

   d. Philip White, manager at DEF, believes the schedule is fairly presented and follows all Uniform Guidance requirements.

3. Which of the following is correct regarding AU-C 580?

   a. It allows limiting representations to those matters that are either collectively or separately material to the financial statements.

   b. It states that materiality is the same for all representations.

   c. It requires the auditor to include an explicit discussion of materiality in the representation letter.

   d. It states that limitations are acceptable for representations that do not relate to amounts included in the financial statements.

4. While concluding her audit of State University, Lydia is attempting to obtain a representation letter. Charlie, the responsible administrative official, refuses to sign the representation letter because the representations relate to the period that occurred prior to the beginning of his term in office. Lydia can resolve this issue by performing all of the following tasks **except**:

    a. Lydia may proceed with the audit without obtaining any additional representation.

    b. Lydia 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.

    c. An auditor may obtain certain representations from officials other than those signing the standard letter.

    d. An auditor may consider obtaining representations from management of component units in the reporting entity.

5. Concerning a material financial statement assertion, what should an auditor do if he or she cannot obtain sufficient appropriate audit evidence?

    a. Determine whether the audit was executed at a level that provides a moderate level of assurance that the financial statements are free of material misstatement.

    b. Express a qualified opinion or disclaim an opinion.

    c. Revise the risk assessment and change further planned audit procedures.

    d. Consider all important audit evidence regardless of if it appears to corroborate or contradict the relevant assertions.

6. Fatima is performing an audit of TR University. While considering the application of significant accounting principles for bias, AU-C 240.29 states that Fatima should do which of the following?

    a. Consider accounting related to subjective measurements and complex transactions.

    b. Determine the business rationale for significant unusual transactions to address the risk of management override of controls by considering whether the business rationale suggests that transactions may have been entered into to perpetrate fraudulent financial reporting or conceal misappropriation of assets.

    c. Determine 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.

    d. Execute a qualitative evaluation of misstatements identified in the financial statements and determine whether the misstatements may indicate possible fraud.

7. Who should certify the data collection form and how should it be certified?

    a. Reviewing attorney; electronic certification.

    b. Auditor; written signature.

    c. Reviewing attorney; written signature.

    d. Both auditee and auditor; electronic certification.

8. According to 2 CFR Section 200.512(a), when must the reporting package be submitted?

   a. The earlier of 25 calendar days after receipt of the auditor's reports or 3 months after the end of the audit period.

   b. The earlier of 30 calendar days after receipt of the auditor's reports or 9 months after the end of the audit period.

   c. The earlier of 60 calendar days after receipt of the auditor's reports or 3 months after the end of the audit period.

   d. The earlier of 60 calendar days after receipt of the auditor's reports or 12 months after the end of the audit period.

9. An audit performed in accordance with AU-C 265, requires communication with those charged with governance of each of the following elements **except**:

   a. All internal control deficiencies.

   b. All material weaknesses in internal controls.

   c. All significant deficiencies in internal controls.

   d. Do not select this answer choice.

10. In a compliance audit, the significance of a control deficiency depends on which of the following?

    a. Qualifications of individuals performing the work.

    b. Potential for noncompliance.

    c. Complexity of the subject matter.

    d. Knowledge of the industry.

11. Skylar is completing her audit of Spring University. AU-C 260.05 identifies specific types of matter to be communicated by Skylar to those charged with governance. AU-C 260.05 indicates that Skylar should do all of the following **except**:

    a. Provide timely observations that are significant and relevant to the responsibility of overseeing the financial reporting process.

    b. Provide an overview of the planned scope and timing of the engagement.

    c. Clearly communicate her responsibilities regarding the audit.

    d. Provide a list of specific representations that should be obtained.

12. Cristiano is concluding his audit of State University. Professional standards require that Cristiano's final assembly and completion of the audit should occur within how many days of the report release date?

    a. 30.

    b. 45.

    c. 50.

    d. 60.

13. Which of the following auditors is properly following policies and procedures regarding audit documentation retention?

    a. Upon audit completion, Aron makes documentation available upon request to the GAO.

    b. Geoff destroys his related workpapers and reports for a contested opinion without seeking guidance from the appropriate parties.

    c. DaMarcus retains his workpapers for a year from the report release date.

    d. Do not select this answer choice.

14. Brad is performing a GAAS financial audit on Uniformed, Inc. Which of the following is one report Brad is required to issue?

    a. Report on written communication of significant deficiencies.

    b. Report on compliance with laws and regulations.

    c. Report on schedule of expenditures.

    d. Report on internal control over financial reporting.

15. The 2 CFR section 200.515(d) requires the auditor to prepare which of the following?

    a. A schedule of findings and questioned costs.

    b. A report on financial statements and on the schedule of expenditures of federal awards (SEFA).

    c. A Yellow Book report on internal control over financial reporting and on compliance and other matters.

    d. A single audit report on compliance with requirements that could have a direct and material effect on internal control over compliance and each major program.

16. Wyndon is performing a single audit of the State of Florida. Wyndon decides to dual date his report. Select one reason why Wyndon would choose to dual date the audit report?

    a. The Yellow Book requires dual dating to document the audit report date and report release date.

    b. Wyndon issues the report on financial statements and the report on internal controls on different dates.

    c. A subsequent event requiring disclosure occurred after the report date but prior to financial statement issuance. Dual dating limits responsibility.

    d. Do not select this answer choice.

17. Which of the following statements is true regarding the auditor's report on the SEFA (Schedule of Expenditures of Federal Awards)?

    a. The GAS/SA Audit Guide suggests combining the report on the financial statements with the reporting on the SEFA when the SEFA is presented with the financial statements.

    b. Paragraph 13.17 of the GAS/SA Audit Guide states that when the reporting on the SEFA is included in the report on the financial statements, the date of the report on the SEFA depends on the date the financial statement audit procedures are completed.

    c. According to AU-C 725.12, the date of the auditor's report on the SEFA could be earlier than the date the auditor completed the procedures required for the SEFA.

    d. In certain circumstances, the date of the in-relation-to opinion on the SEFA may be earlier than the date of the report on the financial statements.

18. There are several ways that auditors and auditees can approach binding reports that are part of the reporting package. In which of the following does the bound reporting package correspond to the same reporting package delivered in the electronic format to be used for filing with the Federal Audit Clearinghouse using IDES?

    a. One package that includes two parts (each bound together): The financial statements and auditor's report and the Yellow Book reports, and the single audit reports.

    b. 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.

    c. One package that includes three parts (each bound together): The financial statements and auditor's report, the Yellow Book reports, and the single audit reports.

    d. Do not select this answer choice.

19. Which of the following modification should be made if, during a single audit, sufficient appropriate audit evidence was not obtained and the auditor concludes that undetected misstatements could be material but not pervasive to the financial statements?

    a. Disclaimer.

    b. Adverse.

    c. Qualified.

    d. Unqualified.

20. Fiona is performing a single audit, and cannot obtain enough appropriate evidence. Which of the following opinions should Fiona express if the possible effects are pervasive?

    a. Disclaimer.

    b. Adverse.

    c. Qualified.

    d. Unqualified.

21. The emphasis-of-matter and other-matter paragraphs differentiate matters included in an auditor's report. Which of the following allows auditors to use either an emphasis-of-matter paragraph or an other-matter paragraph?

    a. Subsequent events and subsequently discovered facts.

    b. Going concern.

    c. Supplementary information.

    d. Reporting on prior-period financial statements.

22. The auditor's standard report on internal control over financial reporting and on compliance and other matters, also known as the Yellow Book report, must include a statement that the auditor has audited the financial statements and must include a reference to the auditor's separate report on 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. Where in the Yellow Book report would these items be disclosed?

    a. Introductory paragraph.

    b. Opinion paragraph.

    c. Next to last paragraph.

    d. Last paragraph.

23. The paragraph: "In our report on the financial statements, our opinion on the aggregate discretely presented component units was qualified because, as discussed in the "Basis for Qualified Opinion on the Aggregate Discretely Presented Component Units" paragraph in the report on the financial statements, although the financial activities of [Name of Omitted Component Unit] are included in the City's basic financial statements as a discretely presented component unit, the financial statements of [Name of Omitted Component Unit] have not been audited, and we were not engaged to audit the financial statements of [Name of Omitted Component Unit] as part of our audit of the City's basic financial statements," is an example of which of the following?

    a. Qualified Opinion—Scope Limitation.

    b. Adverse Opinion.

    c. Qualified Opinion—GAAP Departure.

    d. Disclaimer of Opinion.

24. Willow is preparing and reporting on the schedule of expenditures of federal awards of Metro Nonprofit Organization. Generally, the more information included in the schedule, the fewer follow-up calls from federal agencies. However, not all information include on the list is required. Which of the following is Willow required to include in the schedule?

    a. The subgrant awards numbers assigned by pass-through entities.

    b. Presenting each program year separately rather than combined.

    c. Reconciliation of amounts of the SEFA to the FFR.

    d. Nonfederal information.

25. While performing an audit of ZigZag University, Alejandro concludes that the supplementary information is materially misstated in relation to the financial statements as a whole. Alejandro discusses the matter with management and proposes that the information be revised. What should Alejandro do if ZigZag refuses to revise the supplementary information?

    a. Issue a qualified opinion and describe the reason why the opinion is qualified.

    b. Modify the opinion on the supplementary information and describe the misstatement in the auditor's report.

    c. Issue an adverse opinion and describe the reason why the opinion is adverse.

    d. Consult with an attorney.

26. The report on the schedule of expenditures of federal awards (SEFA) may be presented all of the following ways **except**:

    a. In a separate report included in the report on compliance and on internal control over compliance.

    b. In an other-matter paragraph in the auditor's report on the financial statements.

    c. As a separate, stand-alone report.

    d. As a note on the face of the financial statements.

27. When reporting on internal control over compliance under the Uniform Guidance, auditors are allowed, but not required, to do which of the following?

    a. Report on compliance with contracts, laws, regulations, and grant requirements at the major program level.

    b. Report on the schedule of expenditures of federal awards in relation to the financial statements.

    c. Issue two separate reports, a report on internal control over compliance and a report on compliance.

    d. Report on internal control over compliance with grant requirements, contracts, regulations, and laws at the major program level.

28. Which of the following elements is **not** a required element that should be included in all auditor's reports on compliance and internal control over compliance?

    a. A section called "Report on Compliance for Each Major Federal Program."

    b. A section that restricts the use of the auditor's report.

    c. A title that includes the word independent.

    d. An Introductory paragraph that includes the reporting period.

29. Which of the following statements is true regarding material effect when reporting on compliance with major program requirements?

    a. When reporting on major program compliance in a single audit, the objective is to express an opinion on the effectiveness of the entity's internal control.

    b. The phrase "direct and material effect," when the auditor has identified questioned costs, generally means that compliance will have a material effect.

    c. The Uniform Guidance requires auditors to assess the materiality of instances of noncompliance.

    d. Auditors are not required to form an opinion that noncompliance *will* have a direct and material effect, but only that noncompliance *may* have a direct and material effect.

30. When determining whether a noncompliance item has a material effect, auditors should consider both qualitative and quantitative factors. According to Paragraph 10.10 of GAS/SA Audit Guide, materiality in a compliance audit is affected by all of the following **except**:

    a. How adequate the entity's system is for monitoring compliance and the possible effect of any noncompliance.

    b. The expectations and needs of federal awarding agencies and pass-through entities.

    c. The nature and frequency of identified noncompliance.

    d. The nature of the compliance requirements.

31. Auditees are responsible for which of the following?

    a. Following up and taking corrective action on all audit findings.

    b. Assessing the timeliness and appropriateness of management's actions.

    c. Preparing a schedule of findings and questioned costs (SFQC).

    d. Recognizing the involvement of other auditors.

32. Which of the following statements regarding fraud and noncompliance is correct?

    a. Generally, the auditor is not responsible for disclosing fraud or violations of laws and regulations to parties other than senior management and those charged with governance.

    b. State laws require all fraud or violations of laws or regulations to be reported.

    c. Auditors are required to ascertain that the audit committee is adequately informed about any violations or laws or regulations, even if they are inconsequential.

    d. If auditors determine there is evidence fraud may exist, they are not required to report it to management if inconsequential.

33. *All* material weaknesses and significant deficiencies should be reported in which of the following?

    a. Schedule of expenditures of federal awards.

    b. Management representation letter.

    c. Data collection form.

    d. Schedule of findings and questioned costs.

34. Which of the following statement is true concerning control deficiencies?

    a. Control deficiencies are an example of audit findings.

    b. The Government Auditing Standards require the auditor perform specific procedures to identify deficiencies in internal controls.

    c. A control deficiency includes only a failure in the operation of the control and the design of the control is not considered.

    d. The auditor's evaluation of a control deficiency would not include looking at the deficiency in combination with other deficiencies.

35. Which of the following would **not** be communicated in a management letter?

    a. Sophia communicates matters that are inconsequential.

    b. Matthew communicates matters required to be included in auditor's reports.

    c. Curtiss makes recommendations for improving internal control.

    d. Ericka makes recommendations for operational efficiencies.

36. Which of the following statements regarding what should be included in a management letter is correct?

    a. Management letters should only be addressed to those in senior management.

    b. A reference is made to separate communications of internal control deficiencies and separate reports on internal control, if any.

    c. The letter should include personal identification information.

    d. The management letters should not be submitted to governmental agencies.

37. 2 CFR section 200.516 requires the auditor to report all findings meeting specific criteria in a schedule of findings and questioned costs (SFQC). Findings include significant deficiencies, material instances of noncompliance, material weaknesses, and known questioned costs exceeding which of the following amounts?

    a. $5,000.

    b. $25,000.

    c. $50,000.

    d. $125,000.

38. Nick is reporting on findings that involve a violation of a local ordinance. Generally, where should these findings be reported?

    a. On a separate schedule.

    b. In the engagement letter.

    c. In the schedule of findings and questioned costs.

    d. In the management representation letter.

39. How long are auditees required to keep submissions of the reporting package on file?

    a. One year from the date of submission.

    b. Two years from the date of submission.

    c. Three years from the date of submission.

    d. Five years from the date of submission.

40. Opie is performing an audit of the City of Mayberry. During his audit, Opie loses his documentation prior to the issuance of his report. What should Opie do next?

    a. Recreate the audit documentation for the procedures performed.

    b. Use oral explanations as the principal support for the work performed.

    c. Issue the audit report without the required documentation.

    d. Do not select this answer choice.

GLOSSARY

Auditee: A non-Federal entity that expends Federal awards which must be audited pursuant to the provisions of the Circular.

Audit finding: A deficiency that the auditor is required to report in the schedule of findings and questioned costs.

Auditor: A public accountant or a Federal, state, or local government, audit organization which meets the Government Auditing Standards.

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.

Award: Federal financial assistance (e.g., grants), and Federal cost reimbursement contracts, including awards received from pass-through entities.

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.

Compliance requirement: A requirement which is applicable to a program and may be included in the compliance supplement requirements for the auditor to test.

Data collection form: To streamline the distribution of audit reports and improve the government-wide collection and analysis of single audit results, 2 CFR section 200.512(b) 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 Audit Clearinghouse. The form provides key information about the nonfederal entity, the federal awards it administers, whether the audit was completed in accordance with the Uniform Guidance, and the audit results.

Documentation completion date: The final assembly and completion of the audit file should occur within 60 days of the report release date. AU-C 230.06 refers to this date as the documentation completion date.

Federal audit clearinghouse (FAC): An agent for OMB to maintain a government wide database of single audit results and reports.

Financial statements: Financial statements that reflect the auditee's financial position, results of operations or changes in net assets, and where appropriate, cash flows for the fiscal year audited.

Government auditing standards: Standards for auditing government organizations and programs issued by the United States General Accounting Office and commonly referred to as the Yellow Book.

Internal control over federal programs: A process, affected by an entity's management and other personnel, designed to provide reasonable assurance regarding proper accounting and reporting of transactions, compliance with laws and regulations, and safeguarding assets.

Major program: A program that is audited.

Management decision: An evaluation made by the Federal awarding agency or pass-through entity of the audit findings and corrective action plan, and the issuance of a written decision as to what corrective action is needed.

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.

Non-Federal entity (NFE): A state (including federally-recognized Indian tribes), local government, university, or nonprofit organization.

Pass-through entity (PTE): A non-Federal entity that provides a Federal award to a subrecipient to carry out a Federal program.

Program-specific audit: An audit of one Federal program based on provisions in the Circular.

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.

Recipient: A non-Federal entity that expends Federal awards received directly from a Federal awarding agency to carry out a Federal program.

Report release date: The report release date is the date that the auditor gives the client permission to use the auditor's reports.

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.

SF-SAC form: A data collection form submitted to the Federal Audit Clearinghouse which provides information about the auditor, the auditee and its Federal programs, and the results of the audit.

Single audit: An audit of a non-Federal entity's financial statements and federal awards which meets the requirements of the Circular.

Single audit process: The audit process prescribed in the Uniform Guidance.

Subrecipient: A non-Federal entity that expends Federal awards from a pass-through entity to carry out a Federal program; a subrecipient may also be a recipient of other Federal awards directly from a Federal awarding agency.

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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COMPANION TO PPC'S GUIDE TO SINGLE AUDITS

COURSE 2

PRE-ENGAGEMENT ACTIVITIES AND INTERNAL CONTROL CONSIDERATIONS (GSATG172)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses two elements of governmental auditing related to single audit engagements. Lesson 1 examines the pre-engagement activities associated with this type of engagement. Lesson 2 discusses the related internal control considerations.

PUBLICATION/REVISION DATE: September 2017

RECOMMENDED FOR: Users of *PPC's Guide to Single Audits*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of governmental auditing

CPE CREDIT: 7 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

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 **September 30, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Pre-engagement Activities

Completion of this lesson will enable you to:

- Identify the financial reporting entity and appropriate acceptance and continuance procedures.
- Determine how to establish the engagement terms, whether there is a need for a single audit, the amount of federal awards expended, the frequency of the audit and audit period, and what special planning considerations are needed for initial engagements.

Lesson 2—Internal Control Considerations

Completion of this lesson will enable you to:

- Identify what an auditor must do to obtain an understanding of a governmental entity's internal control.
- Determine responsibilities for internal control in all audits, additional responsibilities for single audits, what controls should be tested, how to perform tests of the operating effectiveness of controls, and how to report responsibilities.

TO COMPLETE THIS LEARNING PROCESS:

Submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
- Fax to: **(888) 286-9070**
- Mail to:

Thomson Reuters
Tax & Accounting—Checkpoint Learning
GSATG172 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) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Pre-engagement Activities

INTRODUCTION

This lesson discusses the procedures for deciding whether to propose for or accept a new engagement, or continue serving as auditors for a single audit engagement and for the early planning stages of such an engagement. Most of these matters receive attention annually before the start of a continuing engagement. However, they are particularly important and more extensive in a new engagement.

At the beginning of all audits, the auditor should perform engagement acceptance and continuance procedures, evaluate compliance with applicable ethics requirements, and establish an understanding with the client about the services to be performed. When the audit is, or might be, a single audit, the auditor also should determine the need for a single audit, the amount of federal awards expended, and the frequency of the audit and the period to be audited. This lesson also discusses planning considerations in initial engagements and provides two case studies on pre-engagement activities (one for a governmental entity and another for a nonprofit organization).

Learning Objectives:

Completion of this lesson will enable you to:
- Identify the financial reporting entity and appropriate acceptance and continuance procedures.
- Determine how to establish the engagement terms, whether there is a need for a single audit, the amount of federal awards expended, the frequency of the audit and audit period, and what special planning considerations are needed for initial engagements.

Authoritative Literature

The authoritative pronouncements that establish requirements or provide guidance that most directly affect early or pre-engagement activities are as follows:

- AU-C 210, *Terms of Engagement*.
- AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.
- AU-C 300, *Planning An Audit*.
- AU-C 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*.
- AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.
- AU-C 620, *Using the Work of an Auditor's Specialist*.
- AU-C 935, *Compliance Audits*.
- Statement on Quality Control Standards (SQCS) No. 8 (QC 10), *A Firm's System of Quality Control*.
- AICPA *Code of Professional Conduct* (the Code) and related interpretations.
- GAO *Government Auditing Standards, 2011 Revision* (the Yellow Book).
- Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). (The most current version of 2 CFR part 200 is in the Electronic Code of Federal Regulations (eCFR) at **www.ecfr.gov**/**cgi-bin**/**text-idx?tpl**=/**ecfrbrowse**/**Title02**/**2cfr200_main_02.tpl**.)

- AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide).
- AICPA Audit and Accounting Guide, *State and Local Governments* (SLG).
- AICPA Audit and Accounting Guide, *Not-for-Profit Entities*.
- AICPA Audit and Accounting Guide, *Health Care Entities*.

AICPA audit and accounting guides and AICPA audit guides are interpretive publications, and, as such, are not auditing standards. Interpretive publications are recommendations on the application of GAAS in specific circumstances, including engagements for entities in specialized industries. Auditors should consider applicable interpretive publications in planning and performing the audit. If an auditor does not apply the auditing guidance included in an applicable interpretative publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

Objective for Pre-engagement Activities

The auditor's objective when performing pre-engagement activities for a single audit is to accept an engagement for a new or existing audit client only when the basis on which the audit will be performed has been agreed to by (a) determining whether the preconditions for an audit are present and (b) establishing that there is a common understanding of the terms of the audit engagement among the auditor, management and, if applicable, those charged with governance. (AU-C 210.03) Preconditions for an audit are discussed later in this lesson.

DETERMINING THE FINANCIAL REPORTING ENTITY

The intent of this course is not to address basic accounting and reporting considerations but rather to focus on considerations pertinent to the single audit. However, a brief discussion of the financial reporting entity is necessary because the auditor has to determine the financial reporting entity before determining the scope of services to be provided to the potential client. This determination is made as part of the pre-engagement activities so that the auditor can arrive at a reasonable fee estimate. It may not be obvious what activities and organizations comprise the financial reporting entity; however, the auditor should apply the criteria that are discussed in the following paragraphs when making this determination. *PPC's Guide to Audits of Local Governments*, *PPC's Guide to Preparing Governmental Financial Statements*, *PPC's Guide to Audits of Nonprofit Organizations*, and *PPC's Guide to Preparing Nonprofit Financial Statements* include detailed discussions of accounting and reporting considerations for governmental and nonprofit organizations.

What Does GAAP Require for a Governmental Unit?

In the audit of a governmental unit, a significant consideration is what activities should be included in the financial statements. The question arises because governmental units, including small local ones, frequently conduct some of their activities through, or are otherwise related to, other organizations. This raises the question of whether an entity is a component unit of another governmental entity. The criteria for making this determination are discussed in the following paragraphs.

GASBS No. 14, *The Financial Reporting Entity*, as amended, establishes criteria for determining which organizations should be included in the financial reporting entity and for reporting the financial information of those organizations.

Definition. GASBS No. 14 defines the *governmental financial reporting entity* as being made up of two parts:

- The primary government, such as:
  - A state government.
  - A general purpose local government (e.g., a municipality or county).
  - A special purpose government (e.g., a school district) that has a separately elected governing body, is legally separate, and is fiscally independent of other state and local governments.

- Component units, which are defined as legally separate:
  - Organizations for which the elected officials of the primary government are financially accountable.
  - Other organizations that must be included to keep the financial statements from being misleading because of the nature and significance of their relationship with the primary government.

Financial Reporting. Financial reporting should present an overview yet allow users to distinguish between the primary government and its component units. GASBS No. 14 provides two methods for reporting component units in the financial statements of the reporting entity: discrete presentation and blending. Most component units will be discretely presented rather than blended.

For those component units that are so closely related to the primary government that they are, in effect, the same as the primary government, GASBS No. 14 requires that the blending method be used. *Blending* means that the component unit's financial data is reported as though the unit is part of the primary government. GASBS No. 14, paragraph 53, as amended, requires blending when one of the following three circumstances is met:

a. There is substantively the same governing body for both the primary government and the component unit—e.g., a school board (the primary government) that also serves as the board of a school building authority (the component unit)—and one of the following criteria also is met:

   (1) there is a financial benefit or burden relationship between the primary government and the component unit, or

   (2) the operational responsibility for the component unit rests with the management of the primary government. (The term *management of the primary government* refers to personnel below the level of the governing board, such as a county executive or city manager. The term *operational responsibility* means that the primary government manages the component unit in essentially the same manner as it manages its own programs, activities, agencies, or departments.)

b. A component unit provides services entirely (or almost entirely) to the primary government or benefits the primary government exclusively (or almost exclusively).

c. A component unit's debt, including leases, is expected to be repaid entirely or almost entirely with the primary government's resources.

d. The component unit is organized as a not-for-profit corporation in which the primary government is identified in the articles of incorporation or bylaws as the sole corporate member. (This blending requirement, which was established by GASBS No. 80, only applies if the not-for-profit entity meets the GASBS No. 14 criteria for being included in the reporting entity.)

GASBS No. 85, Omnibus 2017, which was issued in March 2017, amends GASBS No. 61, paragraph 9, to clarify that for a primary government that is a business-type activity that reports in a single column, blending of a component unit is only allowed if the component unit meets a criterion for blending in GASBS No. 14, paragraph 53, as amended. GASBS No. 85 is effective for periods beginning after June 15, 2017.

All nonfiduciary component units that do not meet the criteria for blending should be reported by discrete presentation in the primary government's government-wide financial statements. *Discrete presentation* means that data for the component units is presented in one or more separate columns to the right of the primary government data columns. Additional information about major component units and nonmajor component units in the aggregate should be presented in either combining statements or in condensed financial statements in the notes.

GASBS No. 14, as amended, also requires information about each *major* discretely presented component unit to be provided in the basic financial statements of the financial reporting entity. When identifying major discretely presented component units, consideration should be given to a component unit's nature and significance in comparison to the primary government generally based on any of the following three factors:

a. The services that the component unit provides to the citizenry are such that reporting that activity separately as a major component unit is considered to be essential to users of the financial statements,

b. The component unit has significant transactions with the primary government, or

c. There is a significant financial benefit or burden relationship with the primary government.

An in-depth discussion of the financial reporting entity is beyond the scope of this course. *PPC's Guide to Audits of Local Governments* (ALG) and *PPC's Guide to Preparing Governmental Financial Statements* (GFS) provide detailed guidance on determining the financial reporting entity.

Consideration of GASBS No. 14 in a Single Audit. This course suggests that the entire financial reporting entity should generally be considered on a combined basis when determining the need for a single audit. However, it should be noted that single audit regulations permit individual departments, agencies, or other organizational units (including component units) to be audited separately. (Reporting entity considerations and determining the need for a single audit are discussed in further detail later in this lesson.) Therefore, the auditor should be sure to consider the requirements of GASBS No. 14 in planning the single audit.

What Does GAAP Require for a Nonprofit Organization?

Nonprofit organizations often have other nonprofit organizations connected with them as associated organizations, affiliated organizations, chapters, or branches. National nonprofit organizations may have state and local chapters with varying degrees of autonomy, while local organizations may have auxiliaries with varied nonprofit activities. These associated organizations, affiliated organizations, chapters, branches, etc., may be separate corporate entities or merely "boards" or committees, and their separate revenue and assets may be substantial or negligible. These associated organizations may be controlled by the nonprofit organization or may operate autonomously. Also, the organizations may be financially interrelated; for example, one of the organizations may solicit funds on behalf of the other, may be financially dependent on the other, or may pay expenses of or transfer resources to the other organization. Sometimes the boards of two or more nonprofit organizations will decide to merge the organizations to expand the reach of their programs and take advantage of operational efficiencies. Nonprofit organizations also sometimes hold ownership interests in for-profit entities.

The accounting methods used to record the various types of relationships vary. Nonprofit organizations use the authoritative guidance in GAAP to assess relationships with other entities in terms of ownership, economic interest, and control to determine whether they are required (or allowed) to consolidate the other entity, record the investment at fair value or by using the equity method, or if other standards apply.

Ownership Interests in For-profit Entities. How a nonprofit organization reports its ownership interest in a for-profit entity generally depends primarily on the amount of control the nonprofit organization has over the for-profit entity's operating and financial policies. GAAP provides guidance for investments in for-profit entities held by nonprofit organizations as follows:

- An organization with a controlling financial interest through direct or indirect ownership of a majority voting interest generally should consolidate the investee.

- The ability to significantly influence the operating and financial policies of the for-profit entity, without the ability to control it, requires the use of the equity method of accounting.

- If the nonprofit organization is unable to significantly influence the operating and financial policies of the for-profit entity, the ownership interest is reported as an investment. (That is, the interest is reported as an investment.)

Generally, a nonprofit organization should consolidate the activities of a for-profit entity in which it has a controlling financial interest (either directly or indirectly). A controlling financial interest is most clearly evidenced by ownership of a majority voting interest. Thus, as a general rule, when an organization directly or indirectly owns more than 50%

of the outstanding voting shares of a for-profit entity, it should account for its investment through consolidation unless—

a. Control does not rest with the organization as majority owner (for example, if a subsidiary is in legal reorganization or bankruptcy, or operates under foreign exchange or governmental restrictions so severe that they cast significant doubt on the organization's ability to control the subsidiary), or

b. Noncontrolling shareholders have certain approval or veto rights that restrict the majority shareholder's powers to control the investee's operations or assets.

Consolidation is also required when control exists through other means. For example, control may exist even though there is a smaller percentage of ownership if it is obtained through a contract, a lease, an agreement with other shareholders or partners, or by court decree.

Programmatic Investments. A *programmatic investment* is an investment that meets both of the following criteria:

a. Its primary purpose is to further the charitable objectives of the nonprofit organization.

b. The production of income or the appreciation of the asset is not a significant purpose (that is, an investor seeking a market return would not enter into the investment).

By definition, programmatic investments that are equity instruments are interests in entities that serve (a) the purpose or mission for which the nonprofit organization exists or (b) the organization's administrative purposes. Thus, the guidance above related to ownership interests in for-profit entities is used to determine whether to consolidate, use the equity method, or use other accounting, for reporting the interest.

Economically Related Nonprofit Organizations. A nonprofit organization may be required to consolidate a related but separate nonprofit organization, depending on the nature of the relationship. Generally, if an organization has a controlling financial interest in the organization, it should consolidate the entity's activities into its financial statements. If the organization does not have a controlling financial interest in the organization, however, it may still be required (or permitted) to consolidate the related entity's activities. In determining how to apply to a financial relationship with another nonprofit organization, an organization should evaluate whether it has a controlling financial interest or an economic interest and control.

Controlling Financial Interest. Generally, a nonprofit organization that has either a direct or indirect controlling financial interest in another nonprofit organization through ownership of a majority voting interest or sole corporate membership should consolidate the other organization's activities into its financial statements.

Economic Interest and Control. *Control* is the direct or indirect ability to determine the direction of an organization's management and policies. An *economic interest* in another nonprofit organization exists when one organization—

a. Holds or uses significant resources to directly or indirectly produce income for or provide services to the other organization, or

b. Is responsible for the other organization's liabilities.

If an organization has an economic interest without control, or control without an economic interest, it should *not* consolidate the activities of the other entity. When both control and an economic interest are present, accounting for the relationship with another nonprofit organization varies depending on whether there is—

a. An economic interest and control through a majority voting interest in the board, or

b. An economic interest and control by other means.

A nonprofit organization that has both an economic interest and control of another nonprofit organization through a majority voting interest in the other organization's board should consolidate that entity's activities into its financial statements unless the majority voting interest does not give the organization control.

Nonprofit organizations sometimes have control over, and economic interests in, other nonprofit organizations as a result of contracts, affiliation agreements, or other means. In such cases, consolidation is permitted but not required.

Certain disclosures are required if an organization does not consolidate its interest in another nonprofit organization in which it has an economic interest and control by other than a controlling financial interest or a majority voting interest.

Combined (Rather Than Consolidated) Financial Statements. In some circumstances, combined financial statements for organizations that are under *common control* (neither organization controls the other organization) may be useful. The principle prerequisites for preparing combined financial statements are—

a. The entities to be combined are under common management or are two or more entities that are related in their activities and controlled by the same entity, and

b. Combined financial statements are more meaningful than separate statements.

An in-depth discussion of GAAP requirements for the reporting of affiliated organizations is beyond the scope of this course. Detailed guidance is provided in *PPC's Guide to Audits of Nonprofit Organizations*.

Audit Scope for a Single Audit—Reporting Entity

All Nonfederal Entities. 2 CFR section 200.514(a) states:

> The audit must cover the entire operations of the auditee, or, at the option of the auditee, such audit must include a series of audits that cover departments, agencies, and other organizational units that expended or otherwise administered Federal awards during such audit period, provided that each such audit must encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and other organizational unit, which must be considered to be a non-Federal entity. The financial statements and schedule of expenditures of Federal awards must be for the same audit period.

Paragraph 6.15 of the GAS/SA Audit Guide further explains the option to elect a series of audits that cover departments, agencies, and other organizational units. When the auditee elects to have a series of audits, the audit scope must be the financial statements and the schedule of expenditures of federal awards for each such department, agency, or other organizational unit, which must be considered a nonfederal entity. Thus, separate financial statements and a separate schedule must be prepared for each of the departments, agencies, or other organizational units. For example, a local government's financial statements may include a school district for which the local government chooses to have a separate single audit. The government's entity-wide financial statements cannot be used as a substitute for separate financial statements for the school district. Unless separate financial statements are prepared for the school district, it cannot have a separate single audit.

In most cases, an entity-wide single audit is usually more desirable than a series of department or agency audits. Performing individual single audits at the department or agency level will generally result in lower materiality levels that result in higher audit costs. Because of the OMB's requirement that the audit scope must be the individual financial statements and schedule of expenditures of federal awards for each department, agency, or other organizational unit, and because many governmental units and nonprofit organizations are required to have entity-wide financial statement audits to meet other reporting requirements, few entities have found it to be cost-effective to limit the single audit to individual departments or agencies.

Based upon the audit scope specified in the quote from 2 CFR section 200.514(a) above, the reporting entity that is included in the scope of the single audit may be different than the reporting entity as defined under GAAP for both governmental units and nonprofit organizations. Governmental unit and nonprofit organization issues are discussed later in this lesson.

In determining the audit scope, the auditor should be familiar with the structure of the governmental unit or nonprofit organization and its operations and all audit requirements. The auditor may consult with the cognizant or oversight agency for audit about the planned audit scope.

Governmental Unit Considerations. In most small entities, one accounting system covers all expenditures, including federal program expenditures, of all departments. In such cases, the incremental cost of auditing the entire entity may be relatively small. In addition, if state or local statutes, or program provisions require audited basic financial statements, separate audits of the components making up the financial reporting entity would probably be more expensive.

One question that often arises when the single audit is limited to individual departments, agencies, or other organizational units, is whether the audit of the *financial statements* should cover the entire operations of the governmental unit or should be limited to the departments, agencies, or other organizational units included in the single audit. 2 CFR section 200.514(a) clarifies that when an entity chooses the option of having a series of audits of individual departments, agencies, or other organizational units, the audit scope must be the financial statements and schedule of expenditures of federal awards for each such department, agency, or other organizational unit. Because of this requirement, and because many governmental units are required to have government-wide financial statement audits to meet other reporting requirements, few governments have found it to be cost-effective to limit the single audit to individual departments or agencies.

Another possible reporting issue may arise when the regulations of a funding federal agency define the award recipient for single audit purposes as only the primary government rather than the entire reporting entity. In that case, a single audit of the primary government organization would satisfy the Uniform Guidance audit requirement.

In addition, for a component unit to be treated as a separate entity for single audit purposes and be excluded from the oversight unit's single audit, the component unit must (a) meet GASBS No. 14 criteria, as amended, including being a *legally separate entity*, and (b) meet the Uniform Guidance requirement for *separate audited financial statements* discussed in the preceding paragraphs. Thus, if the only reporting of a component unit's financial statements is as a component unit in the oversight unit's financial statements or its separate financial statements are not audited, it should be included in the oversight unit's single audit. Compliance with these requirements should prevent the creation of arbitrary entities in an attempt to limit single audit scope. Determination and reporting treatment of federal awards expended by the oversight unit when a component unit has a separate single audit is discussed later in this lesson.

Nonprofit Organization Considerations. Similar to the reporting issue discussed above, an issue that may arise for a nonprofit organization is that the reporting entity that is required to be included in the scope of the single audit may be different than the reporting entity as defined under GAAP. As discussed in Paragraph 13.10 of the GAS/SA Audit Guide, the regulations of certain federal awarding agencies may define the entity to be audited for purposes of a single audit differently than the reporting entity would be defined under GAAP. As previously discussed, GAAP requires the presentation of consolidated financial statements when entities meet certain criteria. The GAS/SA Audit Guide notes that if a federal agency's regulations define the entity differently for single audit purposes, the entity's submitted financial statements must also comply with those requirements. For example, if a federal agency's requirements define the entity as consisting of only the parent entity, then parent-only financial statements would have to be prepared to comply with the federal agency's regulations. If the entity did not also prepare consolidated financial statements as required by GAAP, Paragraph 13.10 of the GAS/SA Audit Guide further states that a modified opinion for the GAAP departure may be required to be expressed on the parent-only financial statements. A case study later in this lesson discusses the need for a single audit of a nonprofit organization and the scope of operations to be covered in such an audit.

PROCEDURES FOR CLIENT ACCEPTANCE AND CONTINUANCE

The auditor's broad responsibilities under professional standards regarding client acceptance and continuance decisions are as follows:

- *Establishing Policies and Procedures:*

  - SQCS No. 8 (QC 10.27) indicates that a firm should establish policies and procedures for accepting and continuing client relationships and specific engagements. Engagements should only be accepted or continued when the firm:

    a. Has the necessary competencies to perform the engagement and has the capabilities, including time and resources, to do so;

    b. Can comply with legal and relevant ethical requirements; and

    c. Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity.

  - *Government Auditing Standards* requires audit firms to include policies and procedures in their systems of quality control that are designed to provide reasonable assurance that the firm will undertake an audit engagement only if it can comply with professional standards, legal requirements, and ethical principles; and can act within its legal mandate or authority.

- *Timing of Procedures.* AU-C 300.06 and AU-C 300.A8 indicate that auditors perform client acceptance and continuance procedures, including evaluating compliance with ethical requirements, prior to performing significant audit activities for the current engagement. (The auditor's requirements when the terms of a proposed engagement contain a scope limitation imposed by management or those charged with governance that the auditor believes would result in a disclaimer of opinion are discussed later in this lesson.)

- *Communicating with Previous Auditors.* AU-C 210.11 states that the successor auditor should request permission from the prospective client to inquire of the predecessor auditor prior to final acceptance of the engagement, about matters that would assist in making the acceptance decision. In determining whether to accept the engagement, the auditor should evaluate the predecessor auditor's response or consider the implications if the predecessor auditor provides no response or a limited response.

- *Establishing Preconditions for an Audit.* AU-C 210 addresses the auditor's responsibilities in agreeing on the terms of an audit which includes establishing that certain preconditions are present. If the preconditions for an audit are not met, the auditor should discuss the matter with management. Unless the auditor is required by law or regulation to accept the engagement, the auditor should not accept the proposed audit engagement. (AU-C 210.08)

Client acceptance/continuance policies and procedures provide reasonable assurance that:

- Engagements that are accepted can reasonably be expected to be completed with professional competence.

- The risks associated with providing professional services in the particular circumstances are appropriately considered.

Many auditors have traditionally viewed the client acceptance/continuance process as a means of gathering information that will allow a decision about whether to accept or continue a client relationship or a specific engagement. However, the information gathered generally affects later steps in the audit process for those clients or engagements that are accepted. For example, acceptance/continuance procedures often provide critical information that can be used by the auditor when establishing an audit strategy, identifying and assessing risks, and

developing a detailed audit plan, as well as for other audit purposes. AU-C 500.A27 specifically notes that audit evidence includes information obtained from client acceptance and continuance procedures.

If issues involving the acceptance or continuance of a client relationship or a specific engagement are identified and the firm decides to accept or continue the client relationship or the specific engagement, SQCS No. 8 (QC 10.28) requires the firm to consider whether any ethical requirements under ET 1.110.010 of the AICPA *Code of Professional Conduct* apply and to document how any issues were resolved.

Preconditions for an Audit

AU-C 210, *Terms of Engagement*, requires the auditor to determine if preconditions for an audit are present. Preconditions for an audit include:

- The use by management of an acceptable financial reporting framework in the preparation and fair presentation of the financial statements.
- The agreement of management that it acknowledges and understands its responsibilities.

Financial Reporting Framework. As a precondition for an audit, the auditor should determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable. The applicable financial reporting framework is the set of accounting principles used by the entity to prepare its financial statements. (This course assumes that entities are following GAAP.) According to AU-C 210.A4, factors to consider when determining whether the financial reporting framework is acceptable include—

- The nature of the entity (for example, a governmental entity or a nonprofit organization).
- The purpose of the financial statements (for example, whether they meet the common financial information needs of a wide range of users).
- The nature of the financial statements (for example, whether they are a complete set of financial statements or a single financial statement).
- Whether law or regulation prescribes the applicable financial reporting framework.

The determination generally is made during the acceptance and continuance procedures. For many clients, the auditor may presume that the applicable reporting framework is acceptable for financial reporting purposes. (AU-C 210.A3)

Additional Basis of Accounting Considerations for Single Audits. The Uniform Guidance does not prescribe the basis of accounting that nonfederal entities may use to prepare their financial statements. However, 2 CFR section 200.514 states that the auditor must determine whether the financial statements are presented fairly in all material respects in accordance with GAAP. In addition, the basis of accounting is an important consideration in determining whether an entity is a low-risk auditee. According to 2 CFR section 200.520(b), an entity cannot be a low-risk auditee unless the financial statements were prepared in accordance with GAAP or a basis of accounting required by state law. For example, a nonprofit organization that prepares financial statements using the tax basis of accounting cannot be considered a low risk auditee.

Agreement of Management. Another precondition for an audit is to obtain the agreement of management that they acknowledge and understand their responsibilities. The agreement generally is obtained through the use of an engagement letter. Engagements letters are discussed later in this lesson.

Management-imposed Scope Limitation. AU-C 210.07 notes that there may be circumstances when management or those charged with governance may impose a limitation on the scope of the auditor's work. If the auditor believes that the scope limitation would result in a disclaimer of opinion on the financial statements as a whole, the auditor should not accept the engagement. However, if the entity is required by law or regulation to have an audit and the scope limitation and disclaimer of opinion are acceptable under the applicable law or regulation, the

auditor may, but is not required to, accept the engagement. AU-C 210.A41 explains that an auditor of a governmental entity may have legal or regulatory requirements to report directly to the legislature or the public if management attempts to limit the scope of the audit.

Risk-based Perspective

When deciding whether to accept or continue a client, the auditor considers the risks related to the engagement. This is a very high-level consideration of whether the risk level related to the engagement, the overall financial statements, and federal programs is greater than normal. For situations that pose greater than normal risk, firm policies determine when a new engagement is declined and when the relationship with a continuing client is terminated.

If a client with greater than normal risk is accepted or continued, there has to be an appropriate audit response to the risk level in the audit plan. A client with greater than normal risk poses a greater risk to the auditor from a business risk perspective (the auditor's own business risk) and also involves a greater risk of material misstatement or material noncompliance. Both AU-C 240.A27 and AU-C 315.07 note that the auditor considers whether procedures relating to the acceptance and continuance of clients and engagements may be relevant in the identification of risks of material misstatement.

For a new engagement, the auditor obtains a general understanding of management's reputation and integrity and of the client's industry, operations, and financial condition through discussions with management, predecessor auditors, and other knowledgeable parties. For a continuing engagement, the auditor considers the same factors, but also considers whether there have been changes that affect the auditor's continuance decision.

The engagement acceptance or continuance decision will normally focus on factors that increase overall financial statement risk and major program risk. Do discussions with the predecessor auditor, attorneys, or others raise any concerns about management's integrity? Are there increased risks due to indications of pressures, opportunities, or incentives for fraudulent financial reporting or material noncompliance on the part of management? Consideration of this information might cause the auditor to decline to accept the engagement or to terminate the client relationship, or might cause the auditor to plan and perform the audit in a different manner.

The early identification of higher risk engagements can help ensure that audit personnel with adequate experience are assigned to the engagement and that sufficient involvement of the partner and manager occur at all stages of the audit, but particularly during the risk assessment process. (This early identification of risks and the associated assignment of appropriate engagement team members helps meet the requirement in AU-C 220.16 that the audit partner needs to be satisfied that the engagement team and any auditor's specialists have the appropriate competencies for the engagement.) Also, the preliminary scheduling of audit work and estimates of audit time (and often, fee estimates) will be affected by any risks that have been identified through client acceptance or continuance; thus, the reporting deadlines established need to allow sufficient time for dealing with the anticipated risk level. In some cases, greater than normal involvement of a second partner in the engagement may be advisable.

Single Audit Procurement Procedures

Entities expending specified amounts of federal awards must follow the procurement standards prescribed in subpart D of the Uniform Guidance when selecting an auditor. These standards may involve a rather detailed and formal process—many entities use a competitive proposal process to select their auditors. The proposal process often results in the entity issuing a request for proposal (RFP) setting forth the services being sought and requesting information from audit firms interested in procuring the engagement. 2 CFR 200.509(a) states that RFPs for audit services must:

- Clearly describe the objectives and scope of the audit.
- Request a copy of the audit firm's peer review report.

The RFP may include other information such as the following:

- Identification of reports and any other services sought.
- Definition of the reporting entity to be included in the single audit.
- Length of the period to be audited and term of the engagement.
- Description of the entity (e.g., description and population of a governmental unit, description of a nonprofit organization's activities and funds, budgetary process, size of budget, or major financing sources).
- Description of accounting policies, systems, data processing, and financial statements and reports.
- Audit standards and requirements to be followed [e.g., *Government Auditing Standards*; Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance)] or an audit guide of a grantor agency.
- Client assistance that will be provided to the auditor.
- Availability of a proposers' conference and of prior years' audit reports and workpapers for prospective auditors to review.
- Timing and deadlines (i.e., estimated date when the client will be ready for the single audit to begin, and deadline for completion of the single audit and submission of the audit reports).
- Peer review requirements of the audit firm.
- Staffing requirements of the audit team (e.g., experience and continuing professional education related to governmental or nonprofit entities).
- Due date and form and content requirements for the auditor's response to the RFP.
- Criteria to be used in evaluating responses to the RFP and selecting an auditor.

2 CFR 200.509(a) explains that factors to be considered when evaluating proposals include the following:

- Responsiveness to the request for proposal,
- Relevant experience,
- Availability of staff with professional qualifications and technical abilities,
- Results of peer and external quality control reviews, and
- The price.

Whenever possible, the auditee must make positive efforts to utilize small businesses, minority-owned firms, and women's business enterprises, in procuring audit services.

Deciding Whether to Propose for a Single Audit Engagement

The RFP may be quite specific as to the content and organization of responses to the RFP (proposals). Complying with the procurement process and developing a proposal can be a time-consuming and expensive undertaking. Therefore, a careful investigation may be particularly beneficial prior to deciding to develop and submit a formal proposal; the auditor ought to assess the desire for a particular single audit engagement and the chances of obtaining it. Information contained in the RFP may provide a basis for this assessment, but it may also be necessary to learn more about the prospective client to decide whether to pursue the engagement and to develop an effective proposal. The prospective auditor may want to consider the following matters before proposing for a new client:

- Does the RFP provide enough information and sufficient time for preparation of an adequate proposal? If it does not, the auditor ought to consider his or her ability or desire to prepare a proposal.

- Are there any professional reasons not to provide services to the entity (e.g., problems with the prospective client's reputation or accounting system inadequacies sufficient to cause auditability problems, etc.)?
- Does the auditor meet AICPA and Yellow Book ethical requirements, including independence requirements? (The independence requirements are discussed later in this lesson.)
- Can the firm meet peer review requirements, including Yellow Book requirements?
- Can professional standards or other relevant requirements be met in providing the requested services? A single audit imposes on the auditor specific continuing education requirements. The auditor ought to be certain that he or she can meet these requirements before proposing for the engagement.
- Can the detailed requirements of the RFP be met? The RFP may indicate strict and concentrated time requirements and deadlines for performing the fieldwork and issuing reports. The auditor has to decide whether the firm has the requisite experience and can allocate the necessary personnel to meet these requirements.
- Is the competition for the prospective client likely to be so intense that there is only a small chance that the firm will be successful in obtaining the engagement? The number and identity of firms likely to be proposing may indicate the intensity of the competition.
- Is the fee likely to be adequate? The auditor needs to consider how low the fee may have to be to obtain the single audit engagement, *all else being equal*, and, on that basis, consider whether the engagement is worth pursuing or accepting.

Some of these considerations are discussed in greater detail in the following paragraphs.

Client Reputation

The auditor considers the reputation of the prospective or continuing client, its management, and those charged with governance. This consideration is especially significant for a governmental or nonprofit client. These entities usually receive more publicity than a business enterprise of comparable size because their activities are normally either public information or of a societal nature. More intense coverage by the news media and others is to be expected. Thus, the auditor ought to carefully evaluate adverse information about a prospective or continuing client to identify and consider whether it is substantive enough to cause him or her not to want to be associated with the entity. The auditor's concern is the client's general honesty, good faith, and forthrightness in its operations and financial reporting and in providing information, responses, and representations for the audit. Consideration may also be given to whether—

- Management and those charged with governance are knowledgeable about the entity's operations.
- Management and those charged with governance are committed to the application of appropriate accounting principles.
- The entity possesses an appropriate organizational structure, including consideration of the nature and purpose of related party relationships.
- Management and those charged with governance have an appropriate attitude about the financial reporting process, including internal controls.
- Management and those charged with governance reflect an appropriate attitude regarding the general nature of audit procedures to be applied, required time commitments and client resources, and level of effort necessary to complete the audit.

In connection with the auditor's initial or recurring retention, the auditor might discuss or correspond with management about significant issues, for example, status of major programs and prior audit findings. Unless all of those charged with governance are involved in managing the entity (which is unlikely in a governmental unit), AU-C 260.14 indicates that significant issues which were discussed or were the subject of correspondence with management should be communicated to those charged with governance.

Sources of Information. Neither quality control standards nor GAAS provide specific requirements on the depth of investigation of a prospective client except for the requirement in AU-C 300.13 to communicate with a predecessor auditor. For purposes of assessing a client's reputation, auditors could consult the following as sources:

- Other CPAs and professionals in the community who serve the client (e.g., attorneys, bankers, and investment advisors).
- Accounts of the entity's activities published in the news media.
- The prospective client's most recent financial statements, internal control and compliance reports, and other information released to the public or filed with regulatory agencies and made a matter of public record.
- The entity's public information office.
- Other oversight units.
- The predecessor auditor.
- For nonprofit organizations, the composition, qualifications, and autonomy of members of those charged with governance.

If the prospective client is well known to the auditor, the only contact may be with the predecessor auditor.

Communication with a Predecessor. Communicating with the predecessor auditor is a necessary procedure because the predecessor auditor may be able to provide information that will assist the successor auditor in determining whether to accept the engagement. The successor auditor may discover that the predecessor auditor and the client have disagreed about accounting principles, auditing procedures, or similarly significant matters. This means that a predecessor may have reached the conclusion that (a) the client lacks integrity or (b) the client may be changing auditors because of a dispute with the predecessor about audit scope or financial statement presentation. Naturally, this kind of information could influence an auditor's decision on the desirability of accepting a prospective client (or approach to the single audit if it is accepted).

AU-C 510.05 defines a predecessor auditor as an auditor from a different audit firm who reported on the most recent audited financial statements or who was engaged to perform but did not complete an audit of the financial statements. This may include an auditor who was engaged to perform an initial audit but did not complete the audit. It may also include an auditor who was engaged subsequent to the most recent audited financial statements (that is, a successor auditor) who did not complete the audit. In the latter case, there may be two predecessor auditors—the auditor who reported on the most recent audited financial statements and the successor auditor who did not complete the audit. Communication about management integrity and other matters should be made of all predecessor auditors.

AU-C 210.A27 clarifies the timing of the communication with the predecessor by indicating that an auditor may make a proposal before communicating with the predecessor. The communication, however, *ought* to happen before final acceptance. In other words, the predecessor is not expected to respond to inquiries until the successor has been selected and has accepted the engagement subject to evaluation of the predecessor's response.

Nature of the Communication. The precise form of the communication with a predecessor is not specified by professional standards. For example, a written communication is not required—simply talking with the predecessor is enough. The essential aspects of the communication are as follows:

- *Client Permission.* An auditor should ask the prospective client to authorize the predecessor to respond fully. (This is necessary because of the ethical requirement for confidentiality.)
- *Specific Questions.* An auditor may ask specifically about certain matters such as:
  - Information that might bear on management's integrity.

- Disagreements with management on accounting principles, auditing procedures, or similar matters.
- The predecessor's understanding of reasons for the change of auditors.
- Communications with those charged with governance regarding fraud and noncompliance with laws and regulations by the entity.
- Communications with management and those charged with governance regarding internal control matters.

As a result of making inquiries of the predecessor auditor, the auditor carefully considers the following situations when making the decision whether to accept a client:

- Disagreements occurred between the prospective client and the predecessor auditor over accounting principles or practices, financial statement disclosures, or audit scope.
- There is no clear reason for the cessation of the client relationship with the predecessor auditor.
- Access to the predecessor auditor's workpapers has been denied.
- The prospective client has been denied service by other CPA firms.

Because of the nature of the organization's financial reporting entity, there may be several predecessor auditors of different components (e.g., branches, component units, or associated organizations). In such cases, the inquiries described above would be made of each predecessor. The auditor should ask the prospective client to authorize the communication with the predecessor(s). (Sometimes the RFP provides that proposing auditors may communicate with the prior auditors and inspect their workpapers.)

Client Refusal to Allow Communication with Predecessor. Unless the client gives authorization, the predecessor may not ethically respond to the successor's inquiries because of the AICPA ethics requirement for confidentiality. If the prospective client refuses permission to talk with the predecessor, the auditor should determine why. Many auditors consider such a refusal sufficient reason to turn down an engagement because it may signal a lack of future cooperation and possible disagreements with the client over accounting and reporting issues, and it may deprive the auditor of other useful information available only from the predecessor.

Communication When Predecessor Auditor Has Ceased Operations. If the predecessor has ceased operations, the auditor still attempts the required communications, according to an AICPA Technical Question and Answer (Q&A 8900.03). If the auditor cannot communicate with the predecessor, that fact is considered in the acceptance decision. However, that does not mean the auditor automatically declines the engagement. The auditor may be able to obtain sufficient information about client integrity and other matters from alternative sources (from attorneys or bankers, by reading the predecessor's prior audit reports and other communications, etc.) to make the acceptance decision.

Assessment of Services

A preliminary discussion with the prospective client is usually necessary to become familiar with the services that will be provided. This allows the auditor to consider whether the firm's resources are adequate to provide those services. It also provides an opportunity to make sure the client understands the nature of the services to be provided. Subsequent fee disputes can be avoided if the client clearly understands that additional fees will be charged for additional services that are later requested.

The nature and extent of the work to be done is established through early discussions with the prospective or continuing client. Even if there is an RFP, discussion may be necessary because officials at the entity may not fully understand the single audit process and, thus, may not adequately communicate their requirements in the RFP. For example, the RFP may not be clear as to the entities to be included in the single audit. It is important that the auditor clearly understand the scope of services being sought because this information is vital in deciding whether to propose for an engagement, in preparing a proposal and reasonable fee estimate, and in planning the single audit once the engagement is obtained.

Type of Audit. During the pre-engagement stage, the auditor determines what type of audit the client actually wants or needs. AU-C 935.08 specifically states that entity management is responsible for identifying the entity's government programs and understanding and complying with the related compliance requirements. The auditor's objectives include identifying supplemental audit and reporting requirements within the governmental audit requirement; that is, requirements in addition to those specified by GAAS and the Yellow Book, and performing the necessary procedures to satisfy those requirements. In particular, the auditor should determine if a single audit is required. The client may not be sufficiently knowledgeable about the specific requirements of the Single Audit Act to determine how it applies. Even if the client does not need a single audit, it may have federal, state, or local grants that call for a financial audit performed in accordance with the GAO's *Government Auditing Standards* or that require additional compliance testing and reporting under specific grant agreements. *Government Auditing Standards* describes the types of audits and attestation engagements that audit organizations perform, or arrange to have performed, of government entities, programs, and federal awards administered by contractors, nonprofit entities, and other nongovernmental entities:

a. Financial audits.

b. Attestation engagements.

c. Performance audits.

Therefore, the auditor should exercise care when determining the specific type of audit or attestation engagement the client is requesting and should consider these requirements and their effect on the engagement.

Determining the Reporting Entity. As previously discussed, it may not be obvious what activities and organizations comprise the reporting entity and need to be included in the single audit. Through discussions with the client, the auditor should determine the reporting entity since this will affect the scope of services to be provided.

Types of Financial Statements. There are a number of types of financial statements that might be issued in a single audit engagement (i.e., financial statements on a GAAP basis or in accordance with a special purpose framework, those that include the entire GAAP reporting entity or only certain organizational units, or those that include supplementary information, etc.). The type of financial statements the client plans to present and the degree of assurance the auditor is to express on each significantly affect the scope of the engagement. For example, the basis of accounting is a consideration in determining whether an entity is a low-risk auditee. 2 CFR section 200.520(b) explains that an entity cannot be a low-risk auditee unless the financial statements were prepared in accordance with GAAP or a basis of accounting required by state law. Thus, a nonprofit organization that prepares financial statements using the tax basis of accounting cannot be considered a low risk auditee.

Nature of Federal Programs. The Uniform Guidance prescribes a risk-based approach to determining major programs. Therefore, the auditor should consider the number and nature of the federal programs when evaluating the scope of the single audit.

Independence

The AICPA and the GAO each have their own independence standards. The main differences between the AICPA and Yellow Book independence standards relate to (a) when the conceptual framework is used and (b) documentation of the assessment of management's skills, knowledge, or experience. AICPA requirements are discussed in more detail below. Yellow Book independence requirements are discussed in more detail later in this lesson.

When the Conceptual Framework Is Used. The AICPA *Code of Professional Conduct* and *Government Auditing Standards* have similar, but not identical, conceptual frameworks for independence. The Yellow Book's conceptual framework is used to evaluate threats to independence when providing nonaudit services that are not specifically prohibited by *Government Auditing Standards*. However, the AICPA's conceptual framework should be used when making decisions about independence matters that are not explicitly addressed in the *Code of Professional Conduct*. As a result, the Yellow Book's conceptual framework will be used more frequently than the AICPA's conceptual framework.

Documentation Requirements. The Yellow Book contains specific documentation requirements related to independence that are in addition to AICPA documentation requirements. The Yellow Book requires the auditor to document—

- The safeguards required if an audit organization is structurally located within a government entity and is considered independent based on those safeguards.

- Consideration of management's ability to effectively oversee a nonaudit service to be provided by the auditor as indicated in the discussion of requirements for performing nonaudit services.

AICPA Independence Requirements. The *Independence Rule* of the AICPA's *Code of Professional Conduct* and its many interpretations are established in ET sections 1.200 through ET 1.295.

Interpretations Specific to Governmental Units. Independence interpretations with guidance that is specifically applicable to governmental units are as follows:

- *Entities Included In State and Local Government Financial Statements* (ET 1.224.020) states that a member who audits the basic financial statements of a governmental financial reporting entity or who audits the financial statements of a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity, or an entity that should be disclosed in the notes to the financial statements, must be independent of the entity, fund, or component unit that the member is auditing.

- *Member of Governmental Advisory Committee* (ET 1.275.020) states that a member's independence with respect to a county is not impaired by a partner or professional employee of the firm serving on (a) a citizens' advisory committee that is studying possible changes in the form of a county government that is an attest client of the firm or (b) an advisory committee appointed to study the financial status of the state in which the county is located.

Interpretations Specific to Nonprofit Organizations. Independence interpretations with guidance that is specifically applicable to nonprofit organizations are as follows:

- *Honorary Director or Trustee of a Not-for-Profit Organization* (ET 1.275.010) states that if a partner or professional employee of a member's firm serves as an honorary director or trustee of a charitable, religious, civic, or similar organization, the member's independence would be impaired unless (a) the position is clearly honorary and held in name only, (b) the individual cannot vote or otherwise participate in board or management responsibilities, and (c) the individual is identified as an honorary director or honorary trustee if listed on letterheads or externally circulated materials.

- *Member of Federated Fund-Raising Organization* (ET 1.275.030) states that if a partner or professional employee of a firm is a director or officer of a federated fund-raising organization (such as the United Way), during the period covered by the financial statements or the period of the professional engagement, the member's independence is impaired with respect to a charity receiving funds that is an attest client of the firm if the fund-raising organization has managerial control over the charity.

- *Member of Organization that Receives Funds From Fund-Raising Organization* (ET 1.275.035) states that if a partner or professional employee of a member's firm serves on the board of directors of an organization during the period covered by the financial statements or during the period of the professional engagement and the organization receives funds from a fund-raising foundation that is an attest client, the member's independence would be impaired if the fund-raising foundation functions solely to raise funds for that organization.

- *Member of a Trade Association* (ET 1.280.020) states that independence would be impaired if a partner or professional employee is simultaneously employed by or associated with a trade association that is an attest client.

Nonattest Services. One concern about meeting independence requirements is the effect of providing nonattest services to the client. For example, an auditor may be asked to assist with preparation of the financial statements

or to provide manual or automated bookkeeping services to clients who are too small to employ an adequate accounting staff. Concerns may arise that an auditor's independence has been impaired in these circumstances. (The Yellow Book standards for nonaudit services are discussed later in this lesson.)

According to ET 1.295, before auditors perform nonattest services, they should determine that the requirements of ET 1.295 have been met. ET 1.295 requires the following with respect to the performance of nonattest services:

- The auditor should not assume management responsibilities for the attest client.
- The client must agree to perform certain specific functions in connection with the nonattest services.
- The auditor should establish and document in writing the understanding with the client regarding the nonattest services.

If the requirements of ET 1.295 have not been met during the period of the audit engagement or the period covered by the financial statements, independence is considered impaired unless, for nonattest services performed during the period covered by the financial statements—

a. the nonattest services were provided before the period of the professional engagement (which begins when a member either signs an engagement letter or other agreement to perform attest services or begins to perform an attest engagement for a client, whichever is earlier),

b. the nonattest service is related to periods before the period covered by the financial statements, and

c. another firm audited the financial statements for the period to which the nonattest services relate.

Although performing an individual nonattest service might not impair independence, the cumulative effect of multiple nonattest services can increase the significance of threats to independence. As discussed in ET 1.295.020, before agreeing to perform the services, the member should evaluate whether the aggregate effect of performing multiple nonattest services results in a significant threat to independence that cannot be reduced to an acceptable level by the application of safeguards. SLG, Paragraph 4.124, indicates that the member should consider whether the safeguards in place reduce the self-review and management participation threats to an acceptable level. If there are no safeguards that eliminate the threat or reduce it to an acceptable level, the member's independence would be impaired. It is not necessary to consider threats that might be created when other network firms within the member's firm's network provide nonattest services.

During an audit engagement, the auditor will often communicate with management about issues related to the engagement. According to ET 1.295.010.04, the following discussions are considered a normal part of an audit engagement and would not be subject to the Interpretation:

- The client's selection and application of accounting standards or policies and financial statement disclosure requirements.
- Whether the client's accounting and financial reporting methods are appropriate.
- Adjusting journal entries proposed by the auditor.
- The form or content of the financial statements.

The auditor is cautioned to consider whether the level of involvement constitutes a separate nonattest service. For example, activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are considered outside the scope of an attest engagement and are, instead, nonattest services. However, such activities would not impair independence provided the requirements of ET 1.295 are met.

Under ET 1.295.030, independence is considered to be impaired if an auditor (or his or her firm) assumes management responsibilities for an attest client. However, the auditor may assist management in those responsibilities. For the auditor to remain independent, before the start of the nonattest engagement, the attest client and its

management should agree to perform all of the following functions in connection with the nonattest services (ET 1.295.040):

- Assume all management responsibilities.
- Oversee the nonattest services, by designating an individual, preferably within senior management, who has suitable skill, knowledge, and/or experience.
- Evaluate the adequacy and results of the services performed.
- Accept responsibility for the results of the services.

The auditor should assess and be satisfied that the designated individual who will oversee the services sufficiently understands the services to be performed by the auditor. It is a best practice for the auditor to document the designated individual who will oversee the services, the assessment of the suitability of their skills, knowledge, and/or experience, and their understanding of the services to be performed.

In addition, the auditor should be satisfied that management will be able to meet all of the above criteria, make an informed judgment on the results of the nonattest services, and be responsible for making the significant judgments and decisions that are management's responsibility. In cases in which the client is unable or unwilling to assume its responsibilities, the auditor's performance of the nonattest services would impair independence.

ET 1.295.050 also requires the auditor to *establish* and *document* in writing, before performing the nonattest service, his or her understanding with the client regarding the following:

- Objectives of the engagement.
- Services to be performed.
- Client's acceptance of its responsibilities.
- Auditor's responsibilities.
- Any limitations of the engagement.

ET 1.295 does not specify how the understanding is to be documented, so the auditor has flexibility. For example, the understanding might be documented in a separate engagement letter, in a separate form in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with an audit engagement. It seems likely that many auditors will document the understanding with the client in the audit engagement letter. There is further discussion of the Yellow Book independence standards below. The AICPA's Professional Ethics Division has issued *Frequently Asked Questions: Nonattest Services Questions* that provides additional guidance on documentation of the understanding with the attest client, as well as the suitable skill, knowledge, and/or experience of the designated individual overseeing the nonattest service. The document can be found at **www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/nonattestservicesfaqs.pdf**. Furthermore, the AICPA has issued a Nonattest Services Toolkit that auditors may find useful when considering the performance of nonattest services. The Toolkit can be found at **www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/DownloadableDocuments/ToolkitsandAids/Nonattest-Services-Toolkit.pdf**.

Certain activities are considered to be management responsibilities and, therefore, impair independence regardless of whether the auditor complies with the other requirements of ET 1.295. In addition, if an auditor assumes a management responsibility for an attest client, the management participation threat created would be so significant that no safeguards could reduce the threat to an acceptable level. ET 1.295 identifies common nonattest service activities and provides guidance on considerations as to whether they impair independence. ET 1.295.030 specifically states that performance of the following activities would be considered a management responsibility, and

would therefore impair an auditor's independence (that is, they would preclude the auditor from being independent):

- Setting policy or strategic direction for the client.
- Directing the client's employees or accepting responsibility for their actions (except as permitted by auditing and attestation standards when using the assistance of internal auditors).
- Authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client or having the authority to do so.
- Preparing source documents evidencing a transaction.
- Having custody of the client's assets.
- Deciding which recommendations of the member or other third parties to implement or prioritize.
- Reporting to those charged with governance on behalf of management.
- Acting as the client's stock transfer or escrow agent, registrar, or general counsel or its equivalent.
- Accepting responsibility for managing a client's project.
- Accepting responsibility for the preparation and fair presentation of the financial statements.
- Accepting responsibility for designing, implementing, or maintaining internal control.
- Performing ongoing evaluations of internal control as part of the client's monitoring activities.

Certain regulatory bodies, such as the SEC, the Government Accountability Office, the Department of Labor, the Public Company Accounting Oversight Board, and state boards of accountancy, may have more restrictive independence requirements for nonattest services than those of the AICPA. According to ET 1.295.010.07, when such rules are applicable to the engagement, the member's independence would be impaired if a member is not in compliance with the rules.

Merger or Purchase of a Firm. When a firm either merges with or acquires another firm or merges with or is acquired by another firm, independence may become impaired as a result. According to ET 1.220.040, *Firm Mergers and Acquisitions,* threats to independence may exist as a result of two types of relationships:

- *Employment or Association with an Attest Client.*
- *Providing Nonattest Services that Would Impair Independence (Prohibited Nonattest Services).*

Employment or Association with an Attest Client. When a partner or professional employee (i.e., as a director, officer, employee, promoter, underwriter, voting trustee, trustee of a pension or profit-sharing trust, or in any capacity equivalent to a member of management) was formerly employed or associated with an entity, and that entity becomes an attest client through a merger or acquisition, independence may become impaired.

According to ET 1.220.040.03, a firm's independence will be considered impaired unless all of the following conditions are met:

- The partner or professional employee terminates the relationship with the attest client prior to the closing date of the merger or acquisition.
- The partner or professional employee does not participate on the attest engagement team.
- The applicable disassociation safeguards in ET 1.277.010.04, *Former Employment or Association with an Attest Client,* that require the covered member to end participation in the attest client's employee benefit plans, are met prior to the closing date of the merger or acquisition.

- As soon as practicable under the circumstances and prior to issuance of the attest report, a responsible individual at the firm assesses the prior relationship that the partner or professional employee had with the attest client and the position that was held at the firm to ensure that independence has not been impaired or, if threats to independence exist, the necessary safeguards are met to eliminate or reduce the threats to an acceptable level.

- The nature of the relationship and any safeguards that were applied are discussed with those charged with governance as soon as practicable and prior to issuance of the attest report.

Providing Prohibited Nonattest Services. Independence threats may exist when an entity becomes an attest client through a merger or an acquisition, and prohibited nonattest services were performed. Under ET 1.220.040, there are significant differences in threats to independence depending on whether the prohibited nonattest services were provided by the firm that was acquiring another firm or by the firm being acquired.

As stated in ET 1.220.040.05, when a firm merges with or acquires another firm, and the acquiring firm provided prohibited nonattest services to an attest client of the acquired firm during the period covered by the financial statements, the threats to independence are not at an acceptable level and cannot be reduced to an acceptable level by the application of safeguards. As result, the acquiring firm's independence is considered impaired with respect to the attest client.

If the acquired firm provided prohibited nonattest services to an attest client of the acquiring firm during the period of the attest engagement or the period covered by the financial statements, under ET 1.220.040.07, independence is considered impaired unless all of the conditions listed in the standard are met.

The nature of the prohibited nonattest services and any safeguards that were applied should be discussed with those charged with governance as soon as practicable and prior to issuance of the audit report. ET 1.220.040.11 encourages the substance of the discussion with those charged with governance be documented.

Independence Requirements—*Government Auditing Standards*. The Yellow Book identifies specific nonaudit services that always impair independence and that auditors are prohibited from providing to audited entities. If a nonaudit service is not specifically prohibited, the auditor is required to assess its impact on independence using the conceptual framework set forth in *Government Auditing Standards*.

Required Period of Independence. According to Paragraph 3.05 of the Yellow Book, the auditor should be independent from an audited entity during both of the following periods of time:

- Any period of time that falls within the period covered by the financial statements or subject matter of the audit.

- The entire period of the professional engagement, which begins when the auditor signs the engagement letter (or other agreement to perform an audit) or actually begins to perform an audit, whichever is earlier.

The period of the professional engagement does not necessarily end when the report is issued. It spans the entire duration of the professional relationship (which, for recurring audits, could cover several periods) and ends with the notification by either party of the termination of the relationship or by issuance of a report, whichever is later.

The Meaning of Independence. Paragraph 3.02 of the Yellow Book states:

> In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be independent.

Independence includes both independence of mind and independence in appearance:

- *Independence of mind* is the state of mind that enables performing an audit without being affected by influences that compromise professional judgment, thereby allowing the auditor to act with integrity and to exercise objectivity and professional skepticism.

- *Independence in appearance* is the absence of circumstances that would cause a reasonable and informed third party, having knowledge of the relevant information, to reasonably conclude that the integrity, objectivity, or professional skepticism of an audit organization or member of the audit team had been compromised.

Paragraph 3.04 of the Yellow Book explains that the auditor should avoid situations that could lead reasonable and informed third parties to conclude that the auditor is not independent and, thus, not capable of exercising objective and impartial judgment on all matters associated with conducting and reporting on the audit.

Conceptual Framework for Independence. The Yellow Book's conceptual framework is used by the auditor to identify, evaluate, and apply safeguards to address threats to independence. It should be used to assess independence for any activity that is not specifically prohibited in the Yellow Book, including new threats that come to the auditor's attention during the audit. Paragraph 3.20 of the Yellow Book states:

> Auditors should evaluate threats to independence using the conceptual framework when the facts and circumstances under which the auditors perform their work may create or augment threats to independence. Auditors should evaluate threats both individually and in the aggregate because threats can have a cumulative effect on an auditor's independence.

The conceptual framework should be applied at the audit organization, engagement, and individual auditor levels to:

- Identify threats to independence and evaluate their significance, both individually and in the aggregate.
- Apply safeguards as necessary to eliminate the threats or reduce them to an acceptable level. (Threats are considered to be at an acceptable level when they no longer compromise an auditor's independence.)

Threats to Independence. Threats to independence are circumstances or activities that could—but do not necessarily—impair independence. The auditor should evaluate threats to independence for any activity not specifically prohibited in the Yellow Book. Paragraph 3.14 of the Yellow Book lists the following broad categories of threats that the auditor should evaluate:

- *Self-interest threat*—the threat of a financial or other interest inappropriately influencing the auditor's judgment or behavior.
- *Self-review threat*—the threat that, when making a judgment significant to an audit, the auditor or audit organization will not appropriately evaluate judgments made or work performed as part of nonaudit services they previously provided.
- *Bias threat*—the threat of the auditor taking a position that is not objective because of his or her political, ideological, social, or other convictions.
- *Familiarity threat*—the threat that a relationship, including that of an immediate or close family member, with the audited entity's management or other personnel will lead the auditor to take a position that is not objective.
- *Undue influence threat*—the threat of external influences or pressures affecting the auditor's ability to make independent and objective judgments.
- *Management participation threat*—the threat resulting when an auditor takes on the role of management or performs management functions.
- *Structural threat*—the threat that an audit organization's position within a government and the structure of that government will impact the audit organization's ability to conduct its work and report results objectively.

Circumstances that result in a threat to independence may involve more than one of the above categories of threats.

The GAS/SA Audit Guide, Paragraph 2.10, explains that whether independence is impaired depends on (a) the nature of the threat, (b) whether it is of such significance that it would compromise the auditor's professional judgment or create the appearance that it may be compromised, and (c) the specific safeguard applied to eliminate the threat or reduce it to an acceptable level.

Safeguards. Safeguards are controls designed to eliminate threats or reduce them to an acceptable level. The GAS/SA Audit Guide, Paragraph 2.11, explains that the auditor applies safeguards that address the specific facts and circumstances relating to significant threats. In some cases, it may be necessary to apply multiple safeguards. Safeguards might be available within the audit organization (such as by having the work reviewed by a professional staff member who is proficient in single audits but who was not a member of the audit team) or they might be externally sourced (such as by consulting with a professional regulatory body). Safeguards may also be available at the audited entity. However, the auditor cannot rely solely on safeguards at the audited entity.

The GAS/SA Audit Guide, Paragraph 2.13, explains that a threat to independence is not at an acceptable level if it could:

- Impact the auditor's ability to perform an audit without being affected by influences that compromise professional judgment, or
- Expose the auditor to circumstances under which a reasonable and informed third party would conclude that the integrity, objectivity, or professional skepticism of the audit organization, or a member of the audit team, had been compromised.

The auditor should determine whether identified threats (a) are at an acceptable level, (b) have been reduced to an acceptable level, or (c) have been eliminated. Both qualitative and quantitative factors should be evaluated when determining a threat's significance. The auditor should determine whether safeguards can be applied to any threats that are not at an acceptable level in order to eliminate them or reduce them to an acceptable level. In making that determination, the auditor should exercise professional judgment and take into account the need for both independence of mind and independence in appearance.

Auditors should evaluate threats both individually and in the aggregate because threats can have a cumulative effect on an auditor's independence. Furthermore, the auditor's evaluation of threats should be ongoing throughout the audit. The GAS/SA Audit Guide, Paragraph 2.12, states that if relevant new information about a threat to independence comes to the auditor's attention during the audit, the auditor should evaluate its significance in accordance with the conceptual framework.

Certain threats may be so significant that they cannot be eliminated or adequately reduced by applying safeguards. Paragraph 3.25 of the Yellow Book explains that, in these circumstances, independence is impaired and the auditor should decline to perform a prospective audit or should terminate the audit, if it had already started.

Management Responsibilities. Paragraph 3.35 of the Yellow Book states that if an auditor takes on (i.e., assumes) management responsibilities for an audited entity, the management participation threat is so significant that no safeguards can reduce it to an acceptable level. In other words, if an auditor leads or directs an entity (including making decisions about acquiring, deploying, or controlling human, financial, physical, and intangible resources), the auditor's independence would be impaired with respect to that entity.

Independence Threat Identified after Report Is Issued. If a threat to independence is identified after the auditor's report is issued, the auditor should evaluate its impact on the audit and on compliance with *Government Auditing Standards*. Paragraph 3.26 of the Yellow Book states that if the newly identified threat impacted the audit and if the report would have been different from the one that was issued, the auditor should communicate in the same manner as originally used to distribute the report to those charged with governance, appropriate entity officials, appropriate officials of organizations requiring or arranging for the audit, and other known users.

If the report had been publicly accessible on the auditor's website, the auditor should remove the report and provide a notification about its removal. The auditor should determine whether it is necessary to perform additional audit procedures in order to reissue the report, including revised findings or conclusions. If the additional audit work does not result in revised findings or conclusions, the original report could be reposted.

Nonaudit Services. Auditors have typically provided a range of nonaudit services for entities for which they also perform audits. The GAO's unofficial position is that any service the auditor provides that is not in the SASs is a *nonaudit service*. This would encompass services such as assisting with preparation of the financial statements, preparing cash-to-accrual conversions, preparing bank reconciliations, etc.

Routine activities that directly relate to an audit, such as providing advice and responding to questions on an informal basis as part of an audit, are not considered nonaudit services. Routine activities usually require only insignificant amounts of time or resources and do not entail (a) a specific project or engagement or (b) the production of a report or other formal work product. Paragraph 3.40 of the Yellow Book explains, however, that activities such as preparing financial statements, converting cash basis financial statements to accrual basis, and preparing reconciliations are nonaudit services that are to be evaluated using the conceptual framework.

Paragraph 3.41 of the Yellow Book clarifies that routine activities that directly relate to an audit include the following:

- Providing advice on an accounting matter as an ancillary part of the financial audit.
- Researching and responding to technical questions on relevant tax laws as an ancillary part of providing tax services.
- Providing advice on routine business matters.
- Educating the entity on matters within the auditors' technical expertise.
- Providing information that is readily available to the auditors, such as best practices and benchmarking studies.

Before accepting an engagement to perform a nonaudit service for an audit client, the auditor should determine whether the nonaudit service would create a threat to independence, either by itself or when combined with other nonaudit services provided. The Yellow Book requires the following:

- The auditor should determine that the entity has designated an individual who has suitable skill, knowledge, or experience, and who understands the services to be performed sufficiently to oversee them. [para. 3.34]
- The auditor should obtain assurance that the client will assume all management responsibilities in connection with the nonaudit services; designate someone (preferably within senior management) who has suitable skills, knowledge, and/or experience to oversee the services; evaluate the adequacy and results of the services; and accept responsibility for the results. [para. 3.37]
- The auditor should establish an understanding with management about the nonaudit service to be provided, the objectives of the service, any limitations of the service, the entity's acceptance of its responsibilities, and the auditor's responsibilities. [para. 3.39]

Related documentation requirements and important nonaudit services considerations for practitioners and peer reviewers are discussed later in this lesson.

Prohibited Nonaudit Services. The Yellow Book identifies specific prohibited nonaudit services that always impair independence, such as:

- Determining or changing journal entries, account codes or classifications for transactions, or other accounting records without management's approval. [para. 3.50]
- Authorizing or approving transactions. [para. 3.50]
- Preparing or making changes to source documents, including the general ledger or subsidiary ledgers, without management's approval. [para. 3.50]

- Providing internal audit assistance that involves the following: [para. 3.53]
  - Establishing internal audit policies or the strategic direction of internal audit activities.
  - Performing procedures that are part of internal control (such as reviewing and approving changes to employee data access privileges).
  - Determining the scope of the internal audit function and resulting work.
- Performing or supervising ongoing internal control monitoring procedures. [para. 3.54]
- Providing IT services that involve the following: [para. 3.56]
  - Designing or developing a financial or other IT system that will be significant to managing an area of operations subject to audit.
  - Making other than insignificant modifications to source code underlying the IT system.
  - Operating or supervising operation of the IT system.

Paragraphs 3.57 and 3.58 of the Yellow Book identify several other nonaudit services that always impair independence. These relate to valuation services, nontax disbursements, administration of benefit plans, investment management or advisory services, corporate finance or advisory services, personnel matters, and business risk consulting.

If a nonaudit service is not specifically prohibited, the auditor should assess its impact on independence using the conceptual framework. Paragraph 3.46 of the Yellow Book explains that the auditor may be able to provide certain nonaudit services without impairing independence if all of the following conditions are met:

- The nonaudit services are not expressly prohibited by the Yellow Book.
- The auditor has determined that the requirements set forth in Paragraphs 3.34–.44 of the Yellow Book for performing nonaudit services have been met.
- Any significant threats to independence have either been eliminated or reduced to an acceptable level by applying safeguards.

A flowchart to assist in the assessment is provided in Appendix II to the Yellow Book.

Paragraph 3.48 of the Yellow Book further explains that a nonaudit service performed during the period covered by the financial statements might not impair the auditor's independence with respect to those financial statements if the following conditions are met:

- The nonaudit service was provided before the period of professional engagement.
- The nonaudit service related only to periods prior to that of the financial statements.
- The financial statements for the period to which the nonaudit service relates were audited by another auditor.

An auditor who previously provided nonaudit services for a prospective audit client should evaluate the impact of the services on independence before accepting the audit engagement. If the nonaudit service was provided in the period to be audited, the auditor should determine if it is specifically prohibited and, if it is not, whether a threat to independence exists. Any identified threats should be addressed by applying the conceptual framework.

Consideration of SKE. It is critically important for auditors to carefully evaluate the skill, knowledge, and experience (SKE) of the individual designated to oversee the nonaudit services and to thoroughly document that evaluation.

The GAS/SA Audit Guide, Paragraph 2.19, explains that although the auditor has to determine whether the entity has designated an individual who has suitable skill, knowledge, or experience, and who understands the nonaudit services sufficiently to oversee them, the individual does not need the expertise to perform or reperform the services. However, if an entity does not have someone with suitable SKE as it relates to the nonaudit service, performing the service would impair independence. Paragraph 2.19 further explains that the consideration of management's ability to effectively oversee the nonaudit services to be performed should be documented, regardless of whether the threats to independence are determined to be significant.

Several important considerations relating to SKE that were covered in a recent AICPA webinar are addressed later in this discussion, including the following:

- The auditor's assessment of whether the client has sufficient SKE to oversee the nonaudit services needs to be a critical, thoughtful process.
- Documentation of SKE is required regardless of the significance of the nonaudit service.
- SKE evaluation is not just checking a box. It should also involve written paragraphs.
- Documenting SKE in the engagement letter and representation letter is not sufficient.
- No safeguards can be put into place to overcome a lack of SKE. If the client does not have SKE, the auditor is not independent.

Documentation. The Yellow Book establishes specific documentation requirements related to independence. Paragraph 3.59 requires the auditor to document the following:

- Threats to independence that require the application of safeguards and the safeguards applied.
- The auditor's consideration of management's ability to effectively oversee nonaudit services.
- The understanding with the entity about the nonaudit service to be provided, the objectives of the service, any limitations of the service, the entity's acceptance of its responsibilities, and the auditor's responsibilities.
- Applicable safeguards if the audit organization is structurally located within a government entity and is considered independent based on those safeguards.

AICPA Guidance for Peer Reviewers. AICPA guidance for peer reviewers, *Evaluation of a Firm's Compliance with 2011 Yellow Book Independence Requirements Related to Nonaudit Services*, indicates that if the auditor did not properly document management's ability to oversee nonaudit services, including whether they have SKE, the auditor may be able to demonstrate to a peer reviewer that its independence was not impaired. The guidance cautions that the burden of proof required of the auditor is high and the evidence would have to be persuasive. However, even if the peer reviewer concludes that the auditor's independence was not impaired, the engagement would not have been performed or reported on in conformity with applicable professional standards in all material respects because the auditor did not comply with the Yellow Book independence documentation requirements. In this circumstance, the peer reviewer would ordinarily prepare a Matter for Further Consideration Form to which the auditor must respond. This guidance for peer reviewers is available on the AICPA website at **www.aicpa.org**/**InterestAreas**/**GovernmentalAuditQuality**/**Resources**/**AuditPracticeToolsAids**/**Pages**/**YellowBookAuditToolsandAids.aspx**.

AICPA Practice Aid for Yellow Book Independence. The AICPA issued *2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid* to assist auditors in applying the independence requirements relating to nonaudit services that are contained in *Government Auditing Standards, 2011 Revision*. The practice aid can be downloaded from the AICPA website at **www.aicpa.org**/**InterestAreas**/**GovernmentalAuditQuality**/**Resources**/**AuditPracticeToolsAids**/**Pages**/ **YellowBookAuditToolsandAids.aspx**.

Documentation. The auditor's consideration of independence based on the 2011 Yellow Book and the auditor's independence considerations under the AICPA *Code of Professional Conduct* should be documented. One method for doing so is using practice aids such as those found in the PPC Guides.

Nonaudit Services Considerations for Practitioners and Peer Reviewers—2011 Yellow Book. The changes to independence are some of the most important changes in the 2011 Yellow Book. A June, 2013 AICPA webinar, *2011 Yellow Book: Evaluation of Independence When Performing Nonaudit Services—A Peer Review Perspective*, discussed several critical considerations (and unofficial GAO positions), including the following:

- It is important to identify nonaudit services before performing the service.
- The GAO's unofficial position is that if the service the auditor performs is not in the SASs, it is not a routine part of the audit. Thus, it is a nonaudit service.
- The auditor's evaluation of nonaudit services should be ongoing throughout the audit.
- It is a best practice to list nonaudit services to be performed in the engagement letter. However, the auditor also still has to do it in a separate assessment.
- Assessing whether the client has sufficient skills, knowledge, and experience (SKE) to oversee the nonaudit services is a critical, thoughtful process.
- Documentation of SKE is applicable regardless of the significance of the nonaudit service.
    - The GAO's unofficial positions are that (a) SKE evaluation is not just checking a box (it should also involve writing paragraphs), and (b) documenting SKE in the engagement letter and representation letter is not sufficient.
    - The timing of SKE documentation is important. Documentation at the conclusion of the audit would probably be questioned by the peer reviewer.
- No safeguards can be put into place to overcome a lack of SKE. If the client does not have SKE, the auditor is not independent.
- If the auditor concludes that the client has sufficient SKE but the auditor subsequently made several material adjustments, a significant threat probably exists. It is important for the firm to document the thought process for this conclusion, but there might be extenuating circumstances that would justify a different conclusion.
- Financial statement preparation will almost always be considered a significant threat for which safeguards should be applied and documented. A conclusion that financial statement preparation is not a significant threat will probably be rare.
    - Because financial statement preparation is such a critical part of the audit, there are not many safeguards available to eliminate this threat or reduce it to an acceptable level.
        - Having Yellow Book engagements go through the firm's independent quality control review (EQCR) *may* be an effective safeguard. However, the reviewer would have to be proficient in the type of audit.
        - Another option for entities that need assistance with drafting the financial statements may be to have a separate firm assist them with that task.
    - The GAO's unofficial position is that even if the client provides all of the information needed to prepare the financial statements and the auditor prepares them because he or she has the report writing software, the auditor is preparing the financial statements.
    - Peer reviewers will also likely check whether the auditor prepared significant reconciliations and other workpapers that are part of the audit documentation.
- A significant peer review consideration is whether there are unidentified threats. Peer reviewers will likely look to see if the firm provided nonaudit services that were not listed or documented. They will focus on financial statement preparation if the firm has not listed that as a nonaudit service being performed.

- Peer reviewers will look at whether the auditor evaluated threats both individually and in the aggregate.
- Indicators of potential significant threats include:
  - Multiple nonaudit services were performed.
  - The nonaudit services were significant to the subject matter of the audit.
  - The auditor made significant assumptions and judgments.
  - The nonaudit services have a significant degree of subjectivity.
  - The entity's books and records are in poor condition.
- Peer reviewers will be alert for other evidence in the workpapers that contradicts conclusions the auditor reached. For example, if the auditor documented that the client had sufficient SKE, but the auditor made several material adjustments, the peer reviewer will consider whether the auditor needed to reevaluate SKE.
- The Yellow Book is very clear that documentation is required for each of the elements of independence.
  - There is a presumption that independence is impaired if required independence elements are not documented. It is up to the firm to prove that independence is not impaired.
  - Good documentation may help a firm overcome peer review concerns.
- If the peer reviewer and the auditor agree that the auditor is not independent, the firm would probably have to retract the auditor's report. It would not be in a position to reissue the report.

These considerations also have implications for audit firms. They provide tips and insights into the Yellow Book requirements and address both implementation issues and common pitfalls.

Restriction on Auditors Preparing Indirect Cost Proposals. 2 CFR section 200.509(b) states that "an auditor who prepares the indirect cost proposal or cost allocation plan may not also be selected to perform the [single] audit . . . when the indirect costs recovered by the auditee during the prior year exceeded $1 million." This restriction relates to all years covered by the indirect cost proposal or cost allocation plan, including the base year used in the calculation and any subsequent years in which the agreement or plan is used to recover costs.

Government Auditing Standards also addresses independence requirements for auditors who prepare indirect cost proposals or cost allocation plans. Under the Yellow Book, activities such as preparation of indirect cost proposals or cost plans are nonaudit services that should be evaluated using the Yellow Book's conceptual framework.

Independence of Principal and Other Auditors of Governmental Financial Statements. Because organizations included in the financial reporting entity (primary government, component units, related organizations, etc.) may be audited by different auditors, questions often arise about the need for independence by all of the auditors involved. As previously discussed, ET 1.224.020, *Entities Included In State and Local Government Financial Statements*, states that the auditor of a governmental reporting entity's basic financial statements or the financial statements of a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity, or an entity that should be disclosed in the notes to the financial statements, must be independent of the entity, fund, or component unit that is audited.

Definition of the Financial Reporting Entity's Basic Financial Statements. For the purpose of ET 1.224.020, a financial reporting entity's basic financial statements issued in accordance with GAAP are as follows:

- The government-wide financial statement (consisting of the entity's governmental activities, business-type activities, and discretely presented component units).

- The fund financial statements (consisting of major funds, nonmajor governmental and enterprise funds, internal service funds, blended component units, and fiduciary funds).
- Other entities disclosed in the notes to the basic financial statements (including related organizations, joint ventures, jointly governed organizations, and component units of another government with characteristics of a joint venture or jointly governed organization).

Requirements for Auditors of the Financial Reporting Entity. Independence considerations for the auditor of the financial reporting entity are as follows:

- The auditor of the basic financial statements must also be independent of any major or nonmajor fund, internal service fund, fiduciary fund, component unit, or entity disclosed in the basic financial statements unless the primary auditor explicitly states reliance on other auditors' reports.
- The auditor is not required to be independent of an entity disclosed in the notes to the basic financial statements if the financial reporting entity is not financially accountable for the other entity and the required disclosure does not include financial information.
- Independence would be impaired if, during the period of the professional engagement or the period covered by the financial statements, the auditor or an immediate family member holds a key position in any of the following entities:
  - A major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity.
  - An entity that should be disclosed in the notes to the basic financial statements.

Requirements for Auditors Who Do Not Audit the Primary Government. Independence considerations for an auditor who does not audit the primary government are as follows:

- The auditor of a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity is not required to be independent of entities that the auditor does not audit.
- The auditor of an entity that should be disclosed in the notes to the basic financial statements of the financial reporting entity is not required to be independent of entities that the auditor does not audit.
- Independence would be impaired if, during the period of the professional engagement or the period covered by the financial statements, the auditor or an immediate family member holds a key position in the primary government.

Employment by Primary Government. In the above situations (i.e., the auditor audits the financial reporting entity or the auditor does not audit the primary government), the auditor and the auditor's immediate family would not be considered employed by the primary government provided that the auditor is any of the following:

- directly elected by voters of the governmental entity with respect to which professional services are performed;
- appointed by a legislative body and subject to removal by a legislative body; or
- appointed by someone other than the legislative body, if the appointment is confirmed by the legislative body and removal is subject to oversight or approval by the legislative body.

ET 0.400 defines a *client* as any person or entity (other than the member's employer) that has engaged the member or the member's firm to provide professional services or a person or entity for which professional services are performed. However, ET 0.400 provides examples of several entities that would not be considered "employers."

Meeting Other Professional Standards and Requirements

Competency. Having obtained information about the scope of service for the particular engagement, the auditor can assess his or her ability to meet professional requirements for performing the work. The auditor considers

knowledge of, and experience with, any specialized accounting or auditing standards that will need to be followed (i.e., adherence to *Government Auditing Standards* or knowledge of the Uniform Guidance, the Compliance Supplement, or relevant government regulations) and, if necessary, considers ways to obtain such knowledge. Also, the auditor considers special requirements relating to independence, integrity and objectivity, and ability to serve as the principal auditor in a single audit.

SQCS No. 8 Requirements. SQCS No. 8 (QC 10.33), *A Firm's System of Quality Control*, requires firms to adopt quality control policies and procedures that provide reasonable assurance that the engagement partner (or other individual responsible for supervising the engagement and signing or authorizing someone else to sign the auditor's report) has the necessary competencies for the engagement. The necessary competencies will vary depending on the client, industry, or type of service being provided. SQCS No. 8 specifically mentions governmental engagements as an industry that requires unique competencies. The quality control policies and procedures should also require that the engagement partner have the appropriate capabilities, authority, and time to perform the role. Policies and procedures may include systems to monitor the workload and availability of engagement partners, allowing these individuals sufficient time to adequately perform their responsibilities. AU-C 220.16 requires the engagement partner to be satisfied that the engagement team has the appropriate competence and capabilities to (a) perform the audit in accordance with professional standards and relevant legal and regulatory requirements and (b) enable the issuance of an auditor's report that is appropriate in the circumstances.

AICPA Competence Requirements. ET 1.300.001 indicates that a firm should only undertake an engagement that can be reasonably expected to be completed with professional competence. Before accepting a new engagement, therefore, an auditor considers whether resources available to the firm are sufficient to meet the requirements of the engagement, including matters such as:

a. Availability and qualifications of staff.

b. Locations to be covered.

c. Specialized accounting or auditing skills needed.

Government Auditing Standards Requirements. The general standard related to competence in the Yellow Book requires that the staff assigned to perform the audit engagement must collectively possess adequate professional competence for the type of work being performed before beginning work on the engagement. The GAS/SA Audit Guide, Paragraphs 2.37–.39, explains that audit firms should determine that the team assigned to a Yellow Book audit collectively has the technical skills, knowledge, and experience necessary to be competent for the engagement before beginning work on that engagement. Staff assigned to a Yellow Book audit should collectively possess:

- Knowledge of *Government Auditing Standards* applicable to the type of work they are assigned and the education, skills, and experience to apply the knowledge to the work being performed.
- General knowledge of the environment in which the auditee operates and the subject matter.
- Skills to enable clear and effective oral and written communication.
- Other skills appropriate to the work being performed, for example skills in:
  - Statistical or nonstatistical sampling, if the work involves the use of sampling.
  - Information technology, if the work involves the review of information systems.
  - Engineering, if the work involves review of complex engineering data.
  - Specialized audit methodologies or analytical techniques, such as the use of complex survey instruments, actuarial-based estimates, or statistical analysis tests.
  - Specialized knowledge in subject matters such as scientific, medical, environmental, educational, or any other specialized subject matters if the work calls for such expertise.

Auditors should also be knowledgeable in GAAP, GAAS, and any other standards used in conjunction with *Government Auditing Standards*.

The Yellow Book states that audit firms should assess skills needed for the engagement, and consider whether its staff has the skills that match those necessary to perform the audit. The Yellow Book, at Paragraph 3.70, states that audit firms should have a process for recruitment, hiring, continuous development, assignment, and evaluation of staff.

Continuing professional education requirements are included as part of the Yellow Book's competence general standard. The Yellow Book, at Paragraph 3.78, clarifies that improving competency and meeting CPE requirements are primarily responsibilities of individual auditors. However, audit firms "should have quality control procedures" that help ensure individual auditors meet their CPE requirements and document completed CPE.

The Yellow Book, at Paragraph 3.75, also requires that auditors either be licensed CPAs, be licensed accountants in states with multi-class licensing systems that recognize licensed accountants other than CPAs, or work for a licensed CPA firm or a government auditing organization.

Quality Control. SQCS No. 8 (QC 10.21), *A Firm's System of Quality Control* requires firms to establish policies and procedures designed to provide reasonable assurance that the firm and its personnel comply with relevant ethical requirements.(QC 10.A7), reiterates the fundamental principles of ethical conduct established by the AICPA *Code of Professional Conduct*. *PPC's Guide to Quality Control* provides a detailed discussion of the AICPA's quality control standard requirements.

***Government Auditing Standards* Ethical Principles.** The Yellow Book establishes the fundamental ethical principles that are the foundation for all work performed under *Government Auditing Standards*. The Yellow Book's ethical principles are not written as specific requirements but, instead, provide a framework that enables auditors to consider the facts and circumstances of each situation. The Yellow Book provides the following ethical principles that are both individual and organizational responsibilities:

- *The Public Interest.* The Yellow Book defines *public interest* as "the collective well-being of the community of people and entities the auditors serve."
- *Integrity.* The Yellow Book indicates that integrity includes conducting work "with an attitude that is objective, fact-based, nonpartisan, and nonideological with respect to audited entities and users of the auditors' reports."
- *Objectivity.* The Yellow Book indicates that objectivity includes independence of mind and independence in appearance, maintaining an attitude of impartiality, having intellectual honesty, and having no conflicts of interest.
- *Proper Use of Government Information, Resources, and Positions.* The Yellow Book indicates that government information, resources, and positions are to be used for official purposes, not personal gain or contrary to law or detrimental to the interests of the audited entity or the audit organization.
- *Professional Behavior.* The Yellow Book emphasizes that expectations for professional behavior include complying with all relevant legal, regulatory, and professional obligations, avoiding any conduct that might bring discredit to the auditor's work (including actions that would cause an objective third party with knowledge of the relevant information to conclude that the auditor's work was professionally deficient), and putting forth an honest effort when performing duties and professional services.

Use of Third-party Service Providers. Audit firms frequently subcontract portions of their work to third-party service providers, including other firms or individual auditors. Third-party service providers are entities that are not controlled by the member or member's firm and individuals not employed by the member or member's firm. Independent contractors used by a CPA meet the definition of third-party service providers.

The following Ethics Interpretations address the use of third-party service providers:

- ET 1.150.040 requires that clients be informed, preferably in writing, that a third-party service provider may be used. The client should be informed before any confidential client information is disclosed to the service

provider. If the client objects, the member should either decline the engagement or perform the services without using the service provider.

- ET 1.300.040 establishes the following requirements:
  - Before using a third-party service provider, the member should ensure that the service provider has the required professional qualifications, technical skills, and other resources.
  - The member must adequately plan and supervise the third-party service provider's professional services to ensure that the services are performed with competence and due professional care.
  - The member must obtain sufficient relevant data to support the work product and comply with all technical standards applicable to the professional services.
- ET 1.700.040 requires doing one of the following before disclosing confidential client information to a third-party service provider:
  - Entering into a contractual agreement with the service provider to maintain the confidentiality of the information and provide reasonable assurance that appropriate procedures are in place to prevent the unauthorized release of confidential information to others.
  - Obtaining specific consent from the client before disclosing confidential client information to the third-party service provider.

Group Audit Considerations—Audit of Financial Statements. Sometimes, such as in a single audit of a governmental entity or a nonprofit organization, part of the work may be performed by other auditors. This situation may be encountered when other auditors audit a component unit or associated organization. AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors*), provides guidance when another auditor audits a component, such as a component unit that is included in the financial statements audited by the group auditor. According to AU-C 600.22, when the group auditor makes use of the work and report of another auditor, whether reference to the other auditor is or is not made, the group auditor is required to obtain an understanding of the following:

a. Whether the component auditor understands and will comply with ethical requirements, in particular independence.

b. The component auditor's professional competence.

The group auditor is also required to request communication from the component auditor indicating that he or she has complied with relevant ethical requirements, including independence and professional competence. Thus, regardless of whether the principal auditor decides to make reference to the other auditor, an independence representation is necessary.

AU-C 600 only applies to audits of group financial statements. AU-C 600 does not apply to engagements in which another auditor performs procedures on financial statements that are not group financial statements. For example, as noted in a nonauthoritative AICPA Technical Question and Answer, *Using Another Accounting Firm to Perform Inventory Observations* (Q&A 8800.43), if another auditor was engaged to observe inventory at an off-site location, AU-C 600 would not apply, and technically, the requirements set forth above are not mandatory. However, it is a best practice to comply with the requirements in the previous paragraph whenever the work of another auditor is used.

PPC's Guide to Audits of Local Governments and *PPC's Guide to Audits of Nonprofit Organizations* provide in-depth discussions of AU-C 600. Additional information on group audits is provided in the AICPA Audit and Accounting Guide, *State and Local Governments*, and the AICPA Audit Risk Alert, *Understanding the Responsibilities of Auditors for Audits of Group Financial Statements—2013*.

Group Audit Considerations—Single Audit. The GAS/SA Audit Guide, Paragraph 16.57, explains that AU-C 600 is, in part, intended to address *aggregation risk* (i.e., the audit risk that results from the aggregation of component financial information). The GAS/SA Audit Guide, Paragraph 16.58, further explains:

> The concept of aggregation risk in AU-C section 600 is not directly applicable to Uniform Guidance compliance audits because each major program is being opined on separately. Unlike a financial statement audit, there is no entity-wide opinion on compliance in a Uniform Guidance compliance audit. Additionally, even when a major program is administered by multiple organizational units, locations, or branches within a major program, because the focus of the Uniform Guidance compliance audit is attribute based (that is, there is either compliance or noncompliance), the concepts of aggregation risk and component materiality as contemplated in AU-C section 600 would not be relevant. Instead, the auditor may have additional sampling considerations in such situations. . . Therefore, as a result of the unique nature of a Uniform Guidance compliance audit, the concept of a component in AU-C section 600 generally should only be applied when other auditors have been separately engaged to perform a portion of a Uniform Guidance compliance audit. In those cases, the auditor should follow the guidance in AU-C section 600 as it relates to other auditors (that is, component auditors), including considerations of whether to make reference to the other auditors in the auditor's report on compliance and on internal control over compliance.

Entities that receive federal awards may engage accounting firms on a joint venture or subcontract basis due to requirements to make positive efforts to use small businesses, minority-owned firms, or women-owned business enterprises. The GAS/SA Audit Guide, Paragraph 16.59, indicates that in these circumstances, it is usually not appropriate to make reference to the other auditors. In the case of a joint audit, each of the auditors participating in the audit will sign the audit reports. The guidance in AU-C 600 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 signer of the report. In the case of a subcontract relationship, the subcontracting auditor often does not issue a separate report. Because there is not a separate report, it would also not be appropriate to make reference to the subcontracting auditor.

Using the Work of a Specialist. Different sections of the auditing standards apply depending on who uses a specialist or how a specialist is used. In the context of the audit, a "specialist" may fall into one of three categories:

- *Auditor's specialist*. This term is applied to individuals or organizations that possess expertise in an area other than accounting or auditing whose work is used by the auditor. An auditor's specialist can either be an internal specialist within the auditor's firm or a network firm or can be an external specialist. The auditor's responsibilities when using the work of these specialists are primarily addressed in AU-C 620, *Using the Work of an Auditor's Specialist*. (AU-C 935 indicates that all portions of AU-C 620 are applicable in a compliance audit.)

- *Management's specialist*. These are individuals or organizations that have expertise in a field other than accounting or auditing who are used by the entity to assist in preparing the financial statements. The auditor's responsibilities when using the work of these specialists are primarily addressed in AU-C 500, *Audit Evidence*.

- *Other specialist*. This course uses this term to refer to individuals on the engagement team or other individuals or organizations with whom the auditor consults who possess expertise in a specialized area of accounting or auditing. Situations involving those specialists are addressed in AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, and AU-C 300, *Planning an Audit*.

The paragraphs that follow primarily discuss the use of an auditor's specialist. An in-depth discussion of management's specialists and other specialists is beyond the scope of this course, but more information is available in *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Audits of Nonprofit Organizations*.

AU-C 620.09 requires the auditor to evaluate the specialist's competence, capabilities, and objectivity for the auditor's purposes. The auditor is not only concerned with whether the specialist has the necessary expertise, but also whether the specialist has the available time and resources to achieve the auditor's objective. To evaluate the competence, capabilities, and objectivity of a specialist, the auditor might consider the matters listed in Exhibit 1-1.

Exhibit 1-1

Matters to Consider When Evaluating the Competence, Capabilities, and Objectivity of an Auditor's Specialist

- Previous experience with the work of the specialist.
- Experience of others with the work of the specialist.
- Discussions with the specialist.
- Professional certifications, memberships in professional bodies or industry associations, licensing, or other external recognition of competence.
- Published papers or books written by the specialist.
- Technical performance standards and industry or licensing requirements related to the specialist's field of expertise.
- Relevance of the specialist's field or experience to the matter for which the specialist's work will be used.
- Competence of the specialist, with respect to accounting and auditing requirements that relate to the matter for which the specialist's work will be used.
- Unexpected events, changes in conditions, or audit evidence obtained that indicate it may be necessary to reconsider the initial evaluation of the specialist's competence, capabilities, and objectivity.
- Circumstances that threaten objectivity, such as self-interests, advocacy, familiarity, self-review, or intimidation.

* * *

In the case of an auditor's external specialist, the evaluation of objectivity should include making inquiries about interests and relationships that may threaten the specialist's objectivity. Inquiries may be made of the entity and the specialist about financial interests, business or personal relationships, or other services that the specialist may be performing for the entity. Also, the auditor might discuss with the specialist if there are any safeguards, such as professional requirements, to reduce those threats to an acceptable level. The auditor may consider obtaining a written representation from the specialist about such matters.

AU-C 620 does not prohibit using specialists who are employees of or related to the client as long as the relationship does not impair the specialist's objectivity. Objectivity might be impaired if the client can directly or indirectly control or significantly influence the specialist because of an employment, ownership, contractual right, or family relationship with the specialist. In such circumstances, the auditor should assess the risk that the specialist's objectivity may be impaired. When the auditor believes that there are relationships or interests that may impair the specialist's objectivity, the auditor may perform additional procedures relating to the assumptions, methods, or findings of the specialist or engage another auditor's specialist.

Understanding the Specialist's Field of Expertise. AU-C 620.10 requires the auditor to obtain a sufficient understanding of the specialist's field of expertise to (a) determine the nature, scope, and objectives of the specialist's work and (b) evaluate the adequacy of that work for the auditor's purposes. The auditor might gain this understanding through discussions with the specialist, experience in auditing other entities that required such expertise, and education or professional development in the field of expertise.

Agreement with the Specialist. The auditor is required to reach agreement with the auditor's specialist on the following matters:

a. *Nature, scope, and objectives of the specialist's work.* Among other things, the agreement might include relevant technical performance standards or other professional or industry requirements that the specialist

will follow. An important consideration is whether the specialist's work is subject to any reservation, limitation, or restriction and the possible implications of that for the auditor.

b. *Roles and responsibilities of the auditor and the auditor's specialist.* The agreement might address, for example, responsibilities for detailed testing of source data; consent for the auditor to discuss the specialist's findings or conclusions with the entity or others and to include them in the basis for a modified opinion; any agreement to inform the specialist of the auditor's conclusions about the specialist's work; and agreement about access to, or retention of, each other's working papers.

c. *Nature, timing, and extent of communication between the auditor and the specialist.* Among other things, the agreement should specify the form of any report to be provided by the specialist. In addition, the auditor might consider including names of partners and staff that will interact with the specialist and procedures for communication.

d. *Need for the specialist to observe confidentiality requirements.* ET 1.700.040 requires auditors to enter into a contractual agreement with third-party service providers to maintain the confidentiality of client information. In addition, other confidentiality requirements might be imposed by law or regulation or by the entity.

The preceding requirements apply regardless of whether the specialist is external to or internal to the audit firm; however, agreement about the need to observe confidentiality requirements might not be necessary for internal specialists because they are subject to the same ethical requirements that apply to the auditor.

The agreement with the specialist is normally in the form of a written engagement letter. However, auditing standards do not explicitly require a written agreement; instead they specify that the agreement should be in writing "when appropriate." The appendix to AU-C 620 lists matters that the auditor may include in engagement letters or other forms of written agreement with the specialist.

Evaluating the Adequacy of the Specialist's Work. AU-C 620.12 requires the auditor to evaluate the adequacy of the work of the auditor's specialist for the auditor's purposes, including the following:

a. *Relevance and reasonableness of the specialist's findings and conclusions and their consistency with other audit evidence.* When evaluating the relevance and reasonableness of the specialist's findings and conclusions, the auditor might consider whether the findings and conclusions are (1) presented consistently with relevant standards of the specialist's profession or industry, (2) clearly expressed with reference to the agreed-upon objectives, scope of work, and standards applied, (3) based on an appropriate period with consideration of relevant subsequent events, and (4) based on a consideration of errors and deviations that the specialist found.

b. *Significant assumptions and methods used by the specialist.* The auditor should obtain an understanding of the specialist's assumptions and methods and evaluate their relevance and reasonableness. The auditor's evaluation should consider the rationale and support provided by the specialist and take into account the auditor's other findings and conclusions. Factors relevant to evaluating whether the assumptions and methods are appropriate and reasonable include whether they are: (1) generally accepted in the specialist's field; (2) consistent with GAAP; (3) consistent with those used by management and if not, the reasons and effects of differences; and (4) dependent on the use of specialized models.

c. *Relevance, completeness, and accuracy of significant source data used by the specialist.* The auditor or the specialist may test source data used by the specialist. For example, if the source data is highly technical in the specialist's field, the specialist may test the data. In such cases, the auditor may make inquiries of the specialist or might supervise or review the tests performed by the specialist in order to evaluate the data's relevance, completeness, and accuracy. Procedures performed to test source data may include verifying the origin of the data, including understanding and possibly testing internal controls over the data and its transmission, and reviewing the data for completeness and internal consistency.

If the work of the specialist is not adequate for the auditor's purposes, the auditor is required to (a) agree with the specialist on the nature and extent of additional work that the specialist needs to do to remedy the situation or (b) perform additional audit procedures. In some cases, both the auditor and the specialist may need to perform additional procedures or the auditor may find it necessary to engage another specialist.

Considering the Nature, Timing, and Extent of Audit Procedures. The auditor's procedures are likely to vary based on the circumstances. When determining the nature, timing, and extent of those procedures, AU-C 620.08 requires consideration of the following:

a. The nature of the matter to which the specialist's work relates.

b. The risks of material misstatement of the matter.

c. The significance of the specialist's work in the context of the audit.

d. Previous knowledge of, and experience with, work performed by the specialist.

e. Whether the specialist is subject to the audit firm's quality control policies and procedures (that is, for internal specialists and those in network firms that share common quality control procedures).

Factors may be present that indicate the need to apply more extensive or different procedures relating to the specialist and his or her work. For example, the auditor may consider it necessary to increase procedures for verifying the competence, capabilities, and objectivity of the specialist; expand the depth of understanding of the specialist's field; obtain a detailed, written engagement letter; or obtain additional or more reliable audit evidence regarding the adequacy of the specialist's work, if one of more of the following factors are present:

- The work of the specialist relates to a significant finding or issue involving subjective and complex judgments.
- The specialist is new to the auditor and there is no prior knowledge of the competence, capabilities, and objectivity of the specialist.
- Procedures performed by the specialist are integral to the audit versus limited to providing advice on an individual matter.
- The specialist is an external specialist and not subject to the audit firm's quality control policies and procedures.

PPC's Guide to Audits of Local Governments and *PPC's Guide to Audits of Nonprofit Organizations* provide in-depth discussions of AU-C 620.

Using the Work of a Specialist—*Government Auditing Standards* Requirements. Paragraph 4.01 of the Yellow Book explains that *Government Auditing Standards* for financial audits incorporates all sections of the AICPA Statements on Auditing Standards, "including the introduction, objectives, definitions, requirements, and application and other explanatory material." The Glossary of Terms accompanying the clarified auditing standards defines *staff* as "including any specialists that the firm employs." In addition, Paragraph 1.07 of the Yellow Book explains that the term *auditor* is used throughout the Yellow Book to describe individuals performing work in accordance with *Government Auditing Standards* (including audits and attestation engagements). Thus, it seems logical that a specialist who is employed by the firm and is working on a Yellow Book audit would be subject to the same requirements, including independence requirements, as all other auditors working on a Yellow Book audit. However, the Yellow Book establishes additional requirements relative to specialists' technical knowledge and continuing education.

Technical Knowledge. Paragraph 3.72 of the Yellow Book states that the staff assigned to conduct a Yellow Book audit "should collectively possess the technical knowledge, skills, and experience necessary to be competent for the type of work being performed before beginning work on that audit." It further indicates that appropriate skills include:

a. statistical or nonstatistical sampling (if the work involves use of sampling);

b. information technology (if the work involves review of information systems);

c. engineering (if the work involves review of complex engineering data);

d. specialized audit methodologies or analytical techniques, such as the use of complex survey instruments, actuarial-based estimates, or statistical analysis tests, as applicable; or

e. specialized knowledge in subject matters, such as scientific, medical, environmental, educational, or any other specialized subject matter (if the work needs such expertise).

Continuing Professional Education. The Yellow Book, at Paragraph 3.81, establishes a requirement for the audit team to determine that internal specialists who are performing work in accordance with *Government Auditing Standards* as part of the audit team, including directing, performing audit procedures, or reporting on the audit, comply with *Government Auditing Standards*, including the CPE requirements. It further states that, because internal specialists apply specialized knowledge in government audits, training in their areas of specialization qualify under the requirement for 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the entity operates. Internal specialists who are consulting on a Yellow Book audit and are not involved in directing, performing audit procedures, or reporting on it are exempt from Yellow Book CPE requirements. However, Paragraph 3.80 of the Yellow Book establishes a requirement for the audit team to determine that such internal specialists are qualified and competent in their areas of specialization. Paragraph 3.79 of the Yellow Book establishes a similar exemption for external specialists and a similar requirement for the audit team to determine that external specialists are qualified and competent in their areas of specialization.

In April 2017, the GAO released an exposure draft (ED) of proposed revisions to *Government Auditing Standards* to update for developments in auditing, accountability, and financial management since the 2011 edition. Among other things, the ED contains a new 4-hour CPE requirement in Yellow Book topics [referred to as the GAGAS Qualification requirement (GAGAS refers to *generally accepted government auditing standards*, another name for *Government Auditing Standards* or the Yellow Book)], required each time a new version of the Yellow Book is issued. The new 4-hour requirement would be part of the 24-hour requirement for training in standards, statutory requirements, regulations, criteria, and guidance applicable to auditing or the objectives for the Yellow Book engagements being conducted. The revision will, when effective, supersede the 2011 edition. GAO plans to announce the effective date when the revised Yellow Book is issued. Auditors can monitor the progress of the project on the GAO's website at **www.gao.gov/yellowbook/overview**. In addition to providing a link to the exposure draft, the GAO website includes a summary of the proposed changes.

Condition of the Financial Reporting System. The auditor ought to obtain sufficient knowledge about the financial reporting system and about the controls relevant to administering federal awards to determine whether an audit is feasible or possible before agreeing to perform one. Information about the financial reporting system will also help the auditor establish a fee estimate and gain a sense of the audit approach necessary. Essentially, the auditor is concerned with what kind of financial reporting system is used and whether there is sufficient use of documents, and accountability for them, to permit the application of audit procedures.

A small governmental unit or nonprofit organization does not need a sophisticated financial reporting system or elaborate controls to be auditable. Although the financial reporting system may be relatively informal, it has to be sufficient to produce evidence to support the assertions that transactions have occurred and that all transactions that need to be recorded have been recorded.

For these reasons, an auditor needs to find out enough about the financial reporting system to consider whether an audit is feasible before agreeing to do one. The knowledge of the financial reporting system needed for this purpose is far less than is necessary to understand the entity and its environment and assess the risks of material misstatement. Essentially an auditor is concerned with what kind of formal financial reporting system exists and whether there is sufficient use of documents and accountability for them to permit the application of audit procedures. Client staff qualifications are also important because underqualified or overworked staff may be unable to provide the auditor with the information needed to complete the engagement. Due to the condition of the financial reporting system, the auditor may decide not to accept the client or engagement. In other situations, the auditor may determine that an audit can be performed, but it is unlikely that an unmodified opinion can be expressed.

Engagement Acceptance Forms

Before accepting an engagement, some firms find it useful to complete checklists that summarize relevant considerations. It is best practice for the firm to formally document the acceptance decision-making process. In addition, AU-C 220.25 requires the auditor to document (a) issues identified concerning compliance with relevant ethical requirements and how they were resolved, (b) conclusions on compliance with applicable independence requirements and any relevant discussions with the firm supporting those conclusions, and (c) conclusions reached about the acceptance and continuance of the client relationship and engagement.

Information gathered in the client acceptance process is considered when identifying risks that could result in material misstatement of the financial statements or material noncompliance. Therefore, when performing client acceptance (and continuance) procedures, the auditor is alert for risks that could result in misstatements at the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures. The auditor also is alert for risks that could result in noncompliance at the major program level and compliance requirement level.

In audit engagements of business enterprises, the auditor typically prepares the engagement letter after having reached an understanding with the client, presents the letter to the client, and obtains the signature of the appropriate client officer. The proposal and acceptance process for single audits is usually quite formal. A formal RFP that contains many of the terms of the engagement may be used. Many entities will develop a contract for the audit. The contract may include provisions such as a limitation on the assignment or subcontracting of all or part of the audit to another CPA firm; a requirement to obtain the client's consent to change audit staff committed to the engagement; monetary penalties for breach of contract, including delays in submitting the audit report; or the entity's right of access to the audit workpapers. The fact that there may be an RFP or a standard contract, or that the client drafts the engagement contract does not reduce the need for the auditor to be involved in that process or to use a written engagement letter in addition to the RFP or contract. The auditor ought to determine that there are no contradictions or conflicts between the provisions in a client-generated contract and those contained in the auditor's engagement letter.

Annual Evaluation for Continuing Engagement

The annual evaluation of clients and engagements generally is performed as part of the planning process for continuing engagements. SQCS No. 8 (QC 10.27) and AU-C 220.14 require the firm to assess its continuing association with a client and the engagement. The continuing auditor may consider the topics discussed in this section when reassessing the desire and ability to retain the engagement. This reassessment is especially important if there has been a high degree of turnover in key management positions. Other reasons to reevaluate whether to continue serving the client include significant changes in financial condition, litigation status, nature of activities, scope of the engagement, or other considerations that would have caused the auditor to reject the client had the conditions existed at the time of the original acceptance. Moreover, general economic conditions, industry risk factors, and other considerations may have changed since the initial client acceptance decision. The assessment considers matters such as (a) being aware of potential legal liability risks, (b) avoiding conflict of interest problems, and (c) monitoring compliance with independence rules.

If the firm obtains information that would have caused it to decline an engagement, had that information been available previously, SQCS No. 8 (QC 10.30) notes that policies and procedures on continuance of the engagement and the client relationship should include consideration of the professional and legal responsibilities that apply to the circumstances, and the possibility of withdrawing from the engagement or from both the engagement and the client relationship. In addition, AU-C 220.15 requires the engagement partner to notify the other members of the firm promptly, whenever information is obtained that would have caused the firm to decline the engagement, so appropriate action can be taken. As part of making a withdrawal decision, the firm considers whether there is a requirement to report the withdrawal decision to regulatory authorities. For those engagements that will be continued, auditors consider whether their engagement continuance procedures provide information that may be relevant in identifying risks of material misstatement due to error or fraud.

Once a client relationship has been established, the firm has more objective information to use in evaluating and reassessing the conclusions reached for each factor considered when the initial client acceptance decision was made. The review of factors affecting the continuance decision is made in light of the increased knowledge about

the client obtained from the prior audit(s) and consideration of changes that have occurred since the prior audit. This review is generally performed at the beginning of an engagement to ensure that no circumstances have occurred since the last engagement that would cause the firm to discontinue providing services to the client. A decision to discontinue services to a client generally is made before work commences on the engagement.

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 is considered a component unit?

    a. The Texas State Government, independently financed.

    b. The Jackson County Government, independently financed.

    c. The Cameron Transit System, financed by the city government.

    d. The Bayside Independent School District, independently financed.

2. A programmatic investment will meet which of the following criteria?

    a. Be associated with ownership interests in for-profit entities.

    b. Allow investors a significant return on their investment.

    c. Be an equity interest.

    d. Further a nonprofit organization's charitable purpose.

3. Which of the following is a precondition for an audit under AU-C 210?

    a. Management uses an acceptable financial reporting framework.

    b. Management has been informed of its responsibilities.

    c. The audit can be performed with little to no risk or risks have been mitigated.

    d. The CPA has the professional competence to perform the engagement.

4. A request for proposal (RFP) must include which of the following?

    a. A list of the services sought, including reports.

    b. A description of the entity to be audited.

    c. The audit standards and requirements that will be followed.

    d. A request for the audit firm's peer review report.

5. The auditor should do which of the following when contacting a predecessor prior to client acceptance?

    a. Use a written, traceable method, such as a letter or email.

    b. Keep the communication secret from the potential client so the predecessor is honest.

    c. Ask specific questions, such as about management's integrity and disagreements with management.

    d. Limit the communication to the single, most important or most recent predecessor.

6. The following auditors are considering performing nonattest services for their governmental audit clients and must determine if doing so could impair their independence. Which auditor has retained his or her independence?

   a. Allison refrains from assuming any management responsibilities, and her client agrees to perform certain functions related to the nonattest services.

   b. Bryant establishes an understanding with the governmental entity about the nonattest services in an oral conversation with management.

   c. Caroline considers her independence from the client based on each nonattest service performed individually.

   d. Douglas performed the services related to the current-period financial statements and the requirements of ET 1.295 were not met.

7. Connor has strong convictions about the area of government in which his potential audit client operates. This is an example of which of the following?

   a. Bias threat.

   b. Familiarity threat.

   c. Self-interest threat.

   d. Undue influence threat.

8. Which of the following would be considered a routine activity as opposed to a nonaudit service?

   a. Establishing internal audit policies.

   b. Changing journal entries.

   c. Responding to informal questions.

   d. Preparing cash-to-accrual conversions.

9. Anthony is engaged to audit a component unit. Which of the following independence considerations will apply?

   a. He must be independent from all of the related government's major funds.

   b. He must be independent from the primary government if the unit is disclosed in its financial statement notes.

   c. If management of the primary government does not have the necessary skill, knowledge and experience (SKE), his independence is impaired.

   d. If his wife holds a position in the primary government, his independence is impaired.

10. An auditor who is independent in mind and appearance, impartial, honest, and has no conflicts of interest, is considered to have which of the following?

    a. Appropriate professional behavior.

    b. Competency.

    c. Integrity.

    d. Objectivity.

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 is considered a component unit? **(Page 154)**

   a. The Texas State Government, independently financed. [This answer is incorrect. As described in GASBS No. 14, a state government is considered a primary government, not a component unit.]

   b. The Jackson County Government, independently financed. [This answer is incorrect. A general purpose local government, such as a municipality or county, is considered a primary government, not a component unit, according to GASBS No. 14.]

   c. The Cameron Transit System, financed by the city government. [This answer is correct. According to GASBS No. 14, a *governmental financial reporting entity* can include both the primary government and component units. The component units are defined as legally separate and can be (1) organizations for which the elected officials of a primary government are financially accountable and (2) other organizations that must be included to keep the financial statements from being misleading because of the nature and significance of their relationship with the primary government. Since the Cameron Transit System is not independently financed, it qualifies as a component unit of the city government.]

   d. The Bayside Independent School District, independently financed. [This answer is incorrect. Per GASBS No. 14, a special purpose government, such as a school district, that has a separately elected governing body, is legally separate, and is fiscally independent of other state and local governments is considered a primary government, not a component unit.]

2. A programmatic investment will meet which of the following criteria? **(Page 157)**

   a. Be associated with ownership interests in for-profit entities. [This answer is incorrect. Nonprofit organizations can have ownership interests in for-profit entities; however, the GAAP guidance for that issue is not associated with guidance for programmatic investments.]

   b. Allow investors a significant return on their investment. [This answer is incorrect. The production of income or the appreciation of asset is *not* a significant purpose for a programmatic investment. Therefore, an investor seeking a market return would not enter into this type of investment.]

   c. Be an equity interest. [This answer is incorrect. By definition, programmatic investments that are equity instruments are interests in entities that serve (1) the purpose or mission for which the nonprofit organization exists or (2) the organization's administrative purposes. However, it is not mandatory for a programmatic investment to be an equity interest.]

   d. Further a nonprofit organization's charitable purpose. [This answer is correct. Programmatic investments must meet two criteria, one of which is that its primary purpose must be to further the charitable objectives of the nonprofit organization.]

3. Which of the following is a precondition for an audit under AU-C 210? **(Page 161)**

   a. Management uses an acceptable financial reporting framework. [This answer is correct. AU-C 210, *Terms of Engagement*, requires the auditor to determine if the preconditions for an audit are present. One of the preconditions for an audit discussed in this guidance is the use by management of an acceptable financial reporting framework in the preparation and fair presentation of the financial statements.]

   b. Management has been informed of its responsibilities. [This answer is incorrect. One of the preconditions of an audit discussed in AU-C 210 is the agreement of management that it acknowledges and understands its responsibilities. Therefore, merely informing management of these responsibilities is not enough—acknowledgement is required.]

c. The audit can be performed with little to no risk or risks have been mitigated. [This answer is incorrect. AU-C 210 does not list little to no risk as a precondition for performing an audit; however, client acceptance/continuance policies and procedures are concerned with this issue. These policies and procedures should provide reasonable assurance that the risks associated with providing professional services in the particular circumstances are appropriately considered. CPAs can accept engagements that have associated risk, but an appropriate audit response is needed.]

d. The CPA has the professional competence to perform the engagement. [This answer is incorrect. Client acceptance/continuance policies and procedures should provide reasonable assurance that engagements that are accepted can reasonably be expected to be completed with professional competence. However, considerations related to these policies and procedures are separate from the preconditions listed in AU-C 210.]

4. A request for proposal (RFP) must include which of the following? **(Page 162)**

a. A list of the services sought, including reports. [This answer is incorrect. RFPs *may* include identification of reports and any other services sought, but this is not one of the requirements of 2 CFR 200.509(a).]

b. A description of the entity to be audited. [This answer is incorrect. 2 CFR 200.5099a) includes two items that must be included in the RFP, neither of which is a description of the entity. However, the RFP *may* include a description of the entity (e.g., description and population of a governmental unit, description of a nonprofit organization's activities and funds, budgetary process, size of budget, major financing sources) if desired.]

c. The audit standards and requirements that will be followed. [This answer is incorrect. This information *may* be included in an RFP, but it is not required by 2 CFR 200.509(a). Examples of this type of information that might be listed include (1) *Government Auditing Standards*; (2) Title 2 U.S. *Code of Federal Regulators* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (the Uniform Guidance); or an audit guide of a grantor agency.]

d. A request for the audit firm's peer review report. [This answer is correct. 2 CFR 200.509(a) states that RFPs for audit services must (1) clearly describe the objectives and scope of the audit and (2) request a copy of the audit firm's peer review report.]

5. The auditor should do which of the following when contacting a predecessor prior to client acceptance? **(Page 165)**

a. Use a written, traceable method, such as a letter or email. [This answer is incorrect. The precise form of the communication with a predecessor is not specified by professional standards. A written communication is not required—simply talking with the predecessor is enough.]

b. Keep the communication secret from the potential client so the predecessor is honest. [This answer is incorrect. An auditor *should* ask the prospective client to authorize the predecessor to respond fully. This is necessary because of the ethical requirement for confidentiality.]

c. Ask specific questions, such as about management's integrity and disagreements with management. [This answer is correct. One of the essential aspects of the communication with the predecessor auditor is asking specific questions. An auditor may ask specifically about certain matters, such as (1) information that might bear on management's integrity; (2) disagreements with management on accounting principles, auditing procedures, or similar matters; (3) the predecessor's understanding of reasons for the change of auditors; (4) communications with those charged with governance regarding fraud and noncompliance with laws and regulations by the entity; or (5) communications with management and those charged with governance regarding internal control matters.]

d. Limit the communication to the single, most important or most recent predecessor. [This answer is incorrect. Because of the nature of the organization's financial reporting entity, there may be several predecessor auditors of different components (e.g., branches, component units, or associated organizations). In such cases, inquiries should be made to each predecessor. The auditor should not limit his or her inquiries to a single predecessor.]

6. The following auditors are considering performing nonattest services for their governmental audit clients and must determine if doing so could impair their independence. Which auditor has retained his or her independence? **(Page 169)**

   a. Allison refrains from assuming any management responsibilities, and her client agrees to perform certain functions related to the nonattest services. [This answer is correct. According to ET 1.295, before auditors perform nonattest services, they should determine that the requirements of ET 1.295 have been met. Among other things, ET 1.295 requires that the auditor not assume management responsibilities for the attest client, and that the client agrees to perform certain specific functions in connection with the nonattest services. Assuming all other requirements of ET 1.295 are met, Allison has currently retained her independence from the governmental entity and can perform the nonattest services.]

   b. Bryant establishes an understanding with the governmental entity about the nonattest services in an oral conversation with management. [This answer is incorrect. According to ET 1.295, the auditor should establish and document in writing the understanding with the client regarding the nonattest services. Since Bryant did not use a written method, such as an engagement letter, or document the understanding in writing otherwise, he has not met the ET 1.295 requirements and is not independent.]

   c. Caroline considers her independence from the client based on each nonattest service performed individually. [This answer is incorrect. Although performing an individual nonattest service might not impair independence, the cumulative effect of multiple nonattest services can increase the significance of threats to independence. As discussed in ET 1.295.020, before agreeing to perform the services, the member should evaluate whether the aggregate effect of performing multiple nonattest services results in a significant threat to independence that cannot be reduced to an acceptable level by the application of safeguards. Therefore, at this time, Caroline cannot consider herself independent from the governmental entity because she has not evaluated the nonattest services in the aggregate.]

   d. Douglas performed the services related to the current-period financial statements and the requirements of ET 1.295 were not met. [This answer is incorrect. If the requirements of ET 1.295 have not been met during the period of the audit engagement or the period covered by the financial statements, independence is considered impaired unless, for nonattest services performed during the period covered by the financial statements (1) the nonattest services were provided before the period of the professional engagements, (2) the nonattest service is related to periods before the period covered by the financial statements, and (3) another firm audited the financial statements for the period to which the nonattest services relate. Therefore, Douglas is not independent.]

7. Connor has strong convictions about the area of government in which his potential audit client operates. This is an example of which of the following? **(Page 173)**

   a. Bias threat. [This answer is correct. According to paragraph 3.14 of *Government Auditing Standards* (the Yellow Book), the bias threat is the threat of the auditor taking a position that is not objective because of his or her political, ideological, social, or other convictions. Therefore, if Connor accepts this engagement, he will need to put safeguards in place against his bias.]

   b. Familiarity threat. [This answer is incorrect. As described in the Yellow Book, the familiarity threat is the threat that a relationship, including that of an immediate or close family member, with the audited entity's management or other personnel will lead the auditor to take a position that is not objective. Connor is not facing the familiarity threat in this scenario.]

c. Self-interest threat. [This answer is incorrect. This is the threat of a financial or other interest inappropriately influencing the auditor's opinions, per the Yellow Book. Based on the information provided above, Connor does not need to worry about the self-interest threat.]

d. Undue influence threat. [This answer is incorrect. As explained in the Yellow Book, the undue influence threat is a threat of external influences or pressures affecting the auditor's ability to make independent and objective judgments. Because Connor is being affected by his internal beliefs, he is not facing the undue influence threat in this situation.]

8. Which of the following would be considered a routine activity as opposed to a nonaudit service? **(Page 175)**

a. Establishing internal audit policies. [This answer is incorrect. Establishing internal audit policies or the strategic direction of internal audit activities is classified as a prohibited nonaudit service by the Yellow Book.]

b. Changing journal entries. [This answer is incorrect. Per the Yellow Book, determining or changing journal entries, account codes or classifications for transactions, or other accounting records without management's approval is a prohibited nonaudit service.]

c. Responding to informal questions. [This answer is correct. Routine activities that directly relate to an audit, such as providing advice and responding to questions on an informal basis as part of an audit, are not considered nonaudit services. Routine activities usually require only insignificant amounts of time or resources and do not entail (1) a specific project or engagement or (2) the production of a report or other formal work.]

d. Preparing cash-to-accrual conversions. [This answer is incorrect. The GAO's unofficial position is that any service the auditor provides that is not in the SASs is a *nonaudit service*. This would encompass services such as assisting with preparation of the financial statements, preparing cash-to-accrual conversions, preparing bank reconciliations, etc.]

9. Anthony is engaged to audit a component unit. Which of the following independence considerations will apply? **(Page 180)**

a. He must be independent from all of the related government's major funds. [This answer is incorrect. The auditor of a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity is *not* required to be independent of entities that the auditor does not audit. Therefore, since Anthony is not auditing the major funds, he does not have to be independent from them.]

b. He must be independent from the primary government if the unit is disclosed in its financial statement notes. [This answer is incorrect. The auditor of an entity that should be disclosed in the notes to the basic financial statements of the financial reporting entity is *not* required to be independent of entities that the auditor does not audit. Therefore, since Anthony is not auditing the primary government, even if the component unit is disclosed in the primary government's financial statement notes, he does not have to be independent from the primary government.]

c. If management of the primary government does not have the necessary skill, knowledge and experience (SKE), his independence is impaired. [This answer is incorrect. It is critically important for auditors to carefully evaluate the SKE of the individual designated to oversee nonaudit services and to thoroughly document that evaluation. However, SKE related to the primary government would not affect Anthony's audit of the component unit, or his independence from that unit.]

d. If his wife holds a position in the primary government, his independence is impaired. [This answer is correct. Independence would be impaired if, during the period of the professional engagement or the period covered by the financial statements, the auditor or an immediate family member holds a key position in the primary government. Therefore, Anthony would not be independent with respect to the component unit if his wife holds such a position.]

10. An auditor who is independent in mind and appearance, impartial, honest, and has no conflicts of interest, is considered to have which of the following? **(Page 182)**

    a. Appropriate professional behavior. [This answer is incorrect. The Yellow Book emphasizes that expectations for professional behavior include complying with all relevant legal, regulatory, and professional obligations; avoiding any conduct that might bring discredit to the auditor's work; and putting forth an honest effort when performing duties and professional service. This is a different aspect of the auditor's behavior than the one described above.]

    b. Competency. [This answer is incorrect. This is an assessment of whether the auditor has the ability to meet professional requirements for performing the work, which is a different consideration than the qualities listed above. It covers issues such as the specialized accounting or auditing skills needed for the engagement.]

    c. Integrity. [This answer is incorrect. The Yellow Book indicates that integrity includes conducting work "with an attitude that is objective, fact-based, nonpartisan, and nonideological with respect to audited entities and users of auditors' reports." While this is an important aspect of the auditor's behavior, it is not the one described above.]

    d. Objectivity. [This answer is correct. The Yellow Book indicates that objectivity includes independence of mind and independence in appearance, maintaining an attitude of impartiality, having intellectual honesty, and having no conflicts of interest.]

ESTABLISHING THE TERMS OF THE ENGAGEMENT WITH THE CLIENT

Once the auditor has accepted a new or continuing engagement, both GAAS and *Government Auditing Standards* require the auditor to establish a written understanding with the client about the services to be performed for each engagement. AU-C 210.09–.10 states that the auditor should agree upon the terms of the audit engagement with management or those charged with governance, as appropriate, and document that agreement in an audit engagement letter or another form of written communication. This course assumes the use of an engagement letter rather than another form of agreement.

Documenting the Understanding with the Client

AU-C 210.10 indicates that the engagement letter should include the following:

- The objective and scope of the engagement.
- Management's responsibilities.
- The auditor's responsibilities.
- A statement that due to the inherent limitations of an audit combined with the inherent limitations of internal control, there is a risk that a material misstatement may not be detected.
- Identification of the applicable financial reporting framework.
- Reference to the expected form and content of reports to be issued by the auditor and a statement that circumstances may occur in which a report may differ from its expected form and content.

As discussed at the beginning of this lesson, one of the preconditions for an audit is to obtain the agreement of management that they acknowledge and understand their responsibilities. That agreement generally is obtained through the use of an engagement letter.

The more specific matters that generally are included in engagement letters are as follows:

- *The Objective and Scope of the Engagement* (i.e., the expression of an opinion on the financial statements and an "in relation to" opinion on the schedule of expenditures of federal awards, as well as reporting on internal control and compliance under *Government Auditing Standards*, the Single Audit Act Amendments of 1996, and the Uniform Guidance).
- *Management's Responsibilities.* Management is responsible for:
  - The financial statements and the selection and application of accounting policies;
  - Designing, implementing, and maintaining effective internal control over financial reporting and compliance;
  - Identifying and ensuring compliance with statutes, regulations, and the terms and conditions of federal awards;
  - The design and implementation of programs and controls to prevent and detect fraud;
  - Informing the auditor about all known or suspected fraud affecting the entity involving (a) management, (b) employees who have significant roles in internal control, and (c) others where the fraud could have a material effect on the financial statements;
  - Informing the auditor of their knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, regulators, or others;

- Making all financial records and related information available to the auditor;
- Providing unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence;
- Providing the auditor with a letter confirming certain representations made during the audit; and
- Adjusting the financial statements to correct material misstatements and providing the auditor with a representation that the effects of any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
- Supplementary information. Under AU-C 725, if the auditor was engaged to report on supplementary information in relation to the financial statements as a whole, management should acknowledge and understand that it is responsible for (a) preparing the supplementary information, (b) providing the auditor with written representation concerning the supplementary information, (c) including the auditor's report on the supplementary information in any document that both contains the supplementary information and indicates the auditor has reported on the supplementary information, and (d) either presenting the supplementary information with the audited financial statements or, if the supplementary information will not be presented, making the audited financial statements readily available to users of the supplementary information no later than the date the supplementary information and auditor's report thereon are issued.

Management also has certain responsibilities when the auditor provides nonattest services, such as bookkeeping services.

- *The Auditor's Responsibilities.* The auditor is responsible for:
  - Conducting the audit in accordance with generally accepted auditing standards, *Government Auditing Standards*, the Single Audit Act Amendments of 1996, and the Uniform Guidance.
  - Issuing a written report upon completion of the audit that is addressed to the appropriate parties, such as the governing body or to the entity itself.
  - Ensuring that those charged with governance are aware of internal control related matters that are required to be communicated under professional standards.
- *The Limitations of the Engagement.* The limitations of an audit conducted in accordance with generally accepted auditing standards generally include that:
  - An audit is designed to obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud (i.e., a material misstatement may remain undetected);
  - An audit is not designed to detect immaterial errors or fraud;
  - The auditor may decline to express an opinion or may withdraw from the engagement if he or she is unable to complete the audit or to form an opinion; and
  - An audit is not designed to provide assurance about internal control or to identify deficiencies in internal control.

Government Auditing Standards broadens the parties that receive the auditor's communication and also specifies additional items to be communicated. The Yellow Book's additional communication requirements are discussed later in this lesson.

Suggested Content of Engagement Letter

Drafting of engagement letters has been largely an individual undertaking. Because the engagement letter is essentially a service contract, some auditors consult their attorneys when drafting it. In preparing the engagement

letter, the auditor considers the particular client circumstances, including the extent of screening prior to accepting the engagement, the perceived riskiness of the engagement, client attitudes and expectations, etc. The auditor also balances the desire for provisions that afford some protection against liability with potential adverse client reaction to language deemed too negative or defensive. The use of the engagement letter to limit liability is discussed below.

Items that should be included in an engagement letter were discussed above. Other key elements commonly included in most engagement letters are:

- Identification of the client.
- Timing of the engagement.
- Client assistance regarding the preparation of schedules.
- Use of third-party service providers.
- Explanation of how fees and expenses will be billed and payment terms.
- Provisions related to suspension or termination of services.
- Client signature.

Additional items that may be discussed in the engagement letter include responding to subpoenas and outside inquiries requesting access to the auditor's workpapers, limitations on the auditor's legal liability, staffing, potential employment discussions with audit personnel, designation of client contacts, record retention, availability of documents, use of specialists or internal auditors, arrangements involving predecessor auditors, alternative dispute resolution, and requests for additional services.

Indemnification Clauses. In some instances, entities have issued RFPs or asked auditors to sign contracts containing clauses indemnifying the client against damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to the attest client's acts. Because such clauses are often included in RFPs and proposed audit contracts, auditors should carefully review those documents to ensure that they are not agreeing to such provisions. ET 1.228.020, *Indemnification of an Attest Client*, states that such an agreement would impair the auditor's independence. On the other hand, according to ET 1.228.010, *Indemnification of a Covered Member*, the engagement letter may include a clause that provides that the attest client would release, indemnify, defend, and hold the covered member (and the covered member's partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from known misrepresentations by management. Such a clause would not impair the auditor's independence.

Some CPA firms include provisions in their engagement letters attempting to limit the firm's legal liability. Examples of such provisions include:

- A limitation on the damages a firm may have to pay for negligent errors or omissions.
- A release from liability if the firm fails to detect misstatements in the financial statements as a result of misrepresentations made by management.
- Indemnification by the client for amounts the firm may have to pay third parties if misstatements are not detected as a result of misstatements made by management.

ET 1.228.010 states that such clauses do not impair a firm's independence.

ET 1.400.060 states that some regulators prohibit the use of indemnification and limitation of liability provisions in agreements for the performance of audit or other attest services, or provide that the existence of such provisions disqualifies a member from rendering such services to those entities. Entering into, or knowingly permitting another individual to enter into, such agreements with a client that is subject to the regulators' requirements would be considered an act discreditable to the profession.

Additional GAAS Requirements for Compliance Audits. AU-C 935.37 states that in a compliance audit, the auditor should communicate the following to those charged with governance, which may also be included within the engagement letter:

- The auditor's responsibilities under GAAS, *Government Auditing Standards*, and the governmental audit requirement, such as the Uniform Guidance.
- An overview of the planned scope and timing of the compliance audit.

Communications Required by *Government Auditing Standards*. The Yellow Book requires auditors to make additional communications when performing Yellow Book audits. The Yellow Book broadens the parties with whom auditors should communicate and specifies the communication of specific information during the planning stage of a financial audit. These requirements are intended to reduce the risk that the needs or expectations of the parties involved may be misinterpreted.

Paragraph 4.03 of the Yellow Book states that the auditor should communicate pertinent information that in his or her professional judgment needs to be communicated to persons contracting for or requesting the audit, and to cognizant legislative committees when the audit is performed pursuant to a law or regulation or when the auditor conducts the work for a legislative committee responsible for overseeing the entity. Where there is not a single person or group responsible for overseeing strategic direction and fulfillment of the entity's accountability obligations, or where the identity of those charged with governance is not clearly evident, the auditor should document the process followed and conclusions reached when identifying the appropriate individuals with whom to communicate. This rule does not apply when the auditees are not specifically identified (such as audits required by the Single Audit Act Amendments of 1996).

Clarification of Report Distribution. The Yellow Book also requires auditors to clarify report distribution responsibilities with the auditee. Paragraph 4.45 of the Yellow Book indicates that if the auditor is to be responsible for report distribution, the auditor should reach agreement with the party contracting for the audit about which officials or organizations will receive the report and the steps being taken to make the report publicly available. It is a good idea to include this clarification in the engagement letter. In addition, the Yellow Book requires additional communications when certain technical assistance activities are performed for the client.

Nonaudit Services. Paragraph 2.12 of the Yellow Book indicates that *Government Auditing Standards* do not apply to professional services other than audits or attestation engagements and would not be reported as having been conducted in accordance with such standards. However, when the auditor performs nonaudit services for an entity for which it also performs audit services under *Government Auditing Standards*, the auditor should communicate with the entity to clarify that the nonaudit services do not constitute an audit under *Government Auditing Standards*.

Engagement Letters for Yellow Book Audits. The GAS/SA Audit Guide, Paragraph 3.07, suggests that the engagement letter include the following items that are particularly pertinent to Yellow Book audits:

- A description of the financial statements to be audited and the reports the auditor expects to prepare and issue.
- The reporting period.
- A statement that the auditing standards to be followed include *Government Auditing Standards*.
- A discussion of management's responsibility for:
  - The preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
  - Complying with applicable laws and regulations.
  - Implementing systems designed to achieve compliance with applicable laws and regulations.

  - Establishing and maintaining effective internal control to help ensure that appropriate goals and objectives are met, following laws and regulations, and ensuring that management and financial information are reliable and properly reported.

  - Identifying and providing report copies of previous audits, attestation engagements, or other studies that directly relate to the objectives of the audit, including whether related recommendations have been implemented.

  - Addressing the auditor's findings and recommendations, and for establishing and maintaining a process to track the status of such findings and recommendations.

  - Taking timely and appropriate action to remedy fraud and noncompliance with provisions of laws, regulations, contracts, and grant agreements or abuse that the auditor reports.

- A statement that because the determination of abuse is subjective, *Government Auditing Standards* does not require auditors to detect abuse.

- A discussion of the responsibilities of both management and the auditor for additional information that accompanies the basic financial statements.

- The following items when nonaudit services will be performed:

  - The nonaudit services to be performed.

  - The objectives of the nonaudit services.

  - A discussion of the entity's acceptance of its responsibilities, including that it (a) assumes all management responsibilities, (b) oversees the nonaudit services by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, or experience, (c) evaluates the adequacy and results of the nonaudit services performed, and (d) accepts responsibility for the results of the nonaudit services.

  - The auditor's responsibilities.

  - Any limitations of the nonaudit services.

- Pertinent information that, in the auditor's professional judgment, needs to be communicated to individuals contracting for or requesting the audit, and to cognizant legislative committees when auditors perform the audit pursuant to a law or regulation, or they conduct the work for the legislative committee that has oversight of the entity.

- Report distribution responsibilities, including which officials or organizations will receive the report and the steps to be taken to make the report available to the public if the auditor is responsible for report distribution.

- A statement that, subject to applicable laws and regulations, appropriate individuals and audit documentation will be made available upon request and in a timely manner to appropriate auditors and reviewers.

- A statement that the auditor will expect to receive written representations related to management's responsibilities.

Engagement Letters for Single Audits. In addition to those items listed previously, the GAS/SA Audit Guide, at Paragraph 6.09, indicates that the following items are examples of the types of information to be included in the engagement letter that are particularly pertinent to audits performed under the Uniform Guidance:

- A statement that the supplementary schedules to be considered in the audit include the schedule of expenditures of federal awards.

- The objective of an audit performed in accordance with the Uniform Guidance.
- A discussion of additional reports the auditor expects to prepare and issue, including limitations on their use.
- A discussion of management's responsibility for:
  - Identifying all federal awards received.
  - Preparing the schedule of expenditures of federal awards (including notes and noncash assistance received) in accordance with Uniform Guidance requirements.
  - Internal control over compliance.
  - Compliance with federal statutes, regulations, and the terms and conditions of federal awards.
  - Following up and taking corrective action on audit findings, including preparing a summary schedule of prior audit findings and a corrective action plan.
  - Submitting the reporting package and data collection form.
- A statement that management will make the auditor aware of significant contractor relationships in which the contractor is responsible for program compliance.
- A discussion of the auditor's responsibilities in a compliance audit of major programs under the Uniform Guidance, including determining major programs, considering internal control over compliance, and reporting responsibilities.
  - With respect to compliance with compliance requirements, this includes a discussion of management's responsibility for (AU-C 935.08):
    - Identifying the entity's government programs and understanding and complying with the compliance requirements.
    - Establishing and maintaining effective controls that provide reasonable assurance that the entity administers government programs in compliance with the compliance requirements.
    - Evaluating and monitoring the entity's compliance with the compliance requirements.
    - Taking corrective action when instances of noncompliance are identified, including corrective action on audit findings of the compliance audit.
- A statement that the parties to whom audit documentation will be made available upon request include federal agencies and the U.S. Government Accountability Office (GAO).

The GAS/SA Audit Guide, Paragraph 17.08, indicates that, relative to the schedule of expenditures of federal awards, the auditor should obtain the agreement of management (which may be part of the engagement letter) that it acknowledges and understands its responsibility for:

- Preparing the schedule of expenditures of federal awards in accordance with the Uniform Guidance.
- Providing the auditor with certain written representations.
- Including the auditor's report on the schedule of expenditures of federal awards in any document that contains the schedule and indicates that the auditor reported on the information.
- Presenting the schedule of expenditures of federal awards with the audited financial statements or, if it will not be presented with the audited financial statements, making the audited financial statements readily available to the intended users of the schedule no later than the date the entity issues the schedule and auditor's report.

Paragraph 6.09 of the GAS/SA Audit Guide also reminds the auditor that additional auditor communications are required by AU-C 935.37, which may also be included within the engagement letter.

DETERMINING IF THE NEED FOR A SINGLE AUDIT EXISTS

Federal Awards and the Expenditure Threshold

The single audit applies to nonfederal entities (primarily governmental units and nonprofit organizations) that expend $750,000 or more in a year in federal awards. A *recipient* is a nonfederal entity that receives federal awards directly from a federal awarding agency to carry out an activity under a federal program. Nonfederal entities that receive a subaward from a pass-through entity to carry out part of a federal program are called *subrecipients*.

Federal Awards. 2 CFR section 200.38 explains that, depending on the context, a federal award is defined as either:

- 2 CFR section 200.38(a):

  a. The federal financial assistance that a nonfederal entity receives directly from a federal awarding agency or indirectly from a pass-through entity, as described in 2 CFR section 200.101; or

  b. The cost-reimbursement contract under the Federal Acquisition Regulations that a nonfederal entity receives directly from a federal awarding agency or indirectly from a pass-through entity, as described in 2 CFR section 200.101.

- 2 CFR section 200.38(b): The instrument setting forth the terms and conditions. The instrument is the grant agreement, cooperative agreement, other agreement for assistance covered in 2 CFR section 200.40(b), or the cost-reimbursement contract awarded under the Federal Acquisition Regulations.

Although the requirements apply to entities that have cost-reimbursement contracts, they do not apply to procurement contracts used to buy goods or services from a contractor. The definition also excludes contracts to operate federal government-owned, contractor-operated facilities (GOCOs).

Federal Financial Assistance. 2 CFR section 200.40 defines *federal financial assistance* as follows:

a. Assistance that nonfederal entities receive or administer in the form of:

   (1) grants,

   (2) cooperative agreements,

   (3) noncash contributions or donations of property (including donated surplus property),

   (4) direct appropriations,

   (5) food commodities, and

   (6) other financial assistance [except assistance listed in item (b) below].

b. For purposes of 2 CFR part 200, subpart F—Audit Requirements, federal financial assistance also includes assistance that nonfederal entities receive or administer in the form of:

   (1) loans,

   (2) loan guarantees,

   (3) interest subsidies, and

   (4) insurance.

Federal financial assistance includes physical items, such as food commodities. However, it does not include amounts received as reimbursement for services rendered to individuals, such as for Medicaid and Medicare, as discussed in the next paragraph. In addition, certain loans provided by the National Credit Union Administration are not considered federal awards expended under the Uniform Guidance, as discussed later in this lesson.

Medicare. 2 CFR section 200.502(h) indicates that Medicare payments that are paid to nonfederal entities for patient care services rendered to eligible individuals are not considered to be federal awards expended. This includes payments to nonprofit health care providers and public hospitals.

Medicaid. 2 CFR section 200.502(i) states that Medicaid funds paid to subrecipients for patient care services rendered to eligible individuals are not considered federal awards expended under the Uniform Guidance. However, Medicaid may be subject to the requirements of the Uniform Guidance if a state "requires the funds to be treated as Federal awards expended because reimbursement is on a cost-reimbursement basis." Because the Medicaid program is operated by each state using federal, state, and local funding, the state may impose certain requirements, including those of the Uniform Guidance. However, federal agencies and pass-through entities requiring additional audits (such as a single audit) are subject to grantor agency variation provisions of the Uniform Guidance, discussed later in this lesson. In addition, Medicaid funds that are paid to states by the federal government are considered federal awards expended and are covered by the Single Audit Act Amendments and the Uniform Guidance.

Certain Loans Provided by the National Credit Union Administration. Guidance relating to certain loans provided by the National Credit Union Administration (NCUA) is included in 2 CFR section 200.502(j), which indicates that loans made from the National Credit Union Share Insurance Fund and the Central Liquidity Facility that are funded by contributions from insured nonfederal entities are not considered federal awards expended. Loans and loan guarantees are discussed in detail later in this lesson.

National Institutes of Health Awards. Appendix VII of the 2017 Compliance Supplement states that, effective for grants and cooperative agreements with budget periods beginning on or after December 26, 2014, and awards that receive supplemental funding on or after December 26, 2014, all awards issued by the National Institutes of Health (NIH) meet the definition of "Research and Development." Such awards must be identified as part of the R&D cluster on the schedule of expenditures of federal awards and the auditor must use the Research and Development cluster in Part 5 when testing any of those awards.

Determining the Applicability of the Uniform Guidance and the Single Audit Act Amendments

Applicability of Uniform Guidance and the Single Audit Act Amendments to Nonfederal Entities. The Uniform Guidance and the Single Audit Act Amendments apply to nonfederal entities that expend specified amounts of federal awards in a year. Nonfederal entities include states, local governments, Indian tribes, institutions of higher education, and nonprofit organizations that carry out a federal award as a recipient or subrecipient. As discussed above, the Uniform Guidance does not apply to procurement contracts used to buy goods or services from a contractor; however, a recipient's procurement activities are subject to the Procurement and Suspension and Debarment compliance requirement.

Applicability of a Single Audit to For-profit Organizations. Neither the Uniform Guidance nor the Single Audit Act Amendments contains audit requirements for profit-making organizations. However, when a recipient subgrants funds to a for-profit subrecipient, the pass-through entity has the same responsibilities as for funds passed through to a nonprofit or governmental subrecipient. 2 CFR section 200.501(h) explains "since this part does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. The agreement with the for-profit subrecipient must describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for Federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the agreement, and post-award audits."

Does the Client Need a Single Audit?

Audit Threshold. The Uniform Guidance does not require every recipient of federal awards to have a single audit, but only those expending a specified amount of federal awards. Also, some entities may satisfy the audit requirement by ways other than a single audit. 2 CFR sections 200.501(a) and (d) provide as follows:

- A nonfederal entity that expends $750,000 or more in its fiscal year in federal awards must have either a single or program-specific audit performed for that year in accordance with 2 CFR part 200 [2 CFR section 200.514 (single audits) or 200.507 (program-specific audits)].

- A nonfederal entity that expends less than $750,000 during its fiscal year in federal awards is exempt from federal audit requirements, unless a federal agency conducts or arranges for an audit in lieu of any financial audit required under any other federal statute or regulation. (The recipients are not exempt from other federal requirements relating to federal awards, including requirements to maintain records. Also, a Yellow Book audit may still be required for recipients that expended less than $750,000 during the year.) The full cost of an additional audit conducted or arranged by a federal agency must be funded by the agency requesting the audit.

In lieu of a federal awarding agency conducting or arranging for an additional audit, it may request that a particular program be audited as a major program.

There is one exception to the single audit requirement for entities that expend $750,000 or more in federal awards. If an entity receives awards under only one program [excluding research and development (R&D)], and the program's statutes, regulations, or the terms and conditions of the federal award do not require a financial statement audit, the entity has the alternative of having an audit made of the one program in accordance with that program's audit requirements (e.g., a program-specific audit) instead of a single audit. For R&D, a program-specific audit may be elected if all awards expended were received from the same federal agency, or the same federal agency and the same pass-through agency *and* such entity(ies) approve in advance a program-specific audit. The terms *federal program* and *cluster of programs*, which could affect an entity's eligibility for a program-specific audit, are defined below. An entity that is exempt from federal audit requirements under the second provision of the "Audit Threshold" paragraph still must make its records available for review by federal officials.

Exhibit 1-2 can be used to determine the type of audit required under the Uniform Guidance:

Exhibit 1-2

Determining Audit Requirements

Total Federal Awards Expended	One Program[a]	More Than One Program
$0–$749,999	No Single Audit	No Single Audit
$750,000 or More	Program-specific or Single Audit	Single Audit

Note:

[a] The program (or cluster of programs) may not be a research and development program and federal statutes, regulations, or the terms and conditions of the federal award cannot require a financial statement audit of the organization.

* * *

Programs and Clusters of Programs. Auditors should focus on *programs*, not separate awards, when determining major programs or assessing whether a program-specific audit may be elected. The Uniform Guidance broadens the definition of programs to address a "cluster of programs." 2 CFR section 200.42 defines a *federal program* as:

- All federal awards which are assigned a single *Catalog of Federal Domestic Assistance* (CFDA) number.
- When no CFDA number is assigned, all federal awards from the same agency made for the same purpose must be combined and considered one program.
- Awards defined as a cluster of programs.

2 CFR section 200.17 defines *cluster of programs* as follows:

> . . . a grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development (R&D), student financial aid (SFA), and other clusters.

2 CFR section 200.17 states that a cluster of programs must be considered as one program when determining major programs and, with the exception of R&D, whether a program-specific audit may be elected.

The GAS/SA Audit Guide, Paragraph 15.31, cautions that neither the auditor nor the award recipient may create its own cluster of programs, even if the programs share common compliance requirements. They also may not de-cluster a cluster of programs that is defined by the OMB or designated by a state.

When proposing or planning for an engagement for an audit of financial statements, it is important that the auditor determine whether a single audit is required. The client may know that it needs a single audit at the time it engages the auditor. Some clients, however, may not be aware of these requirements. Others may be unsure because they are borderline cases (i.e., federal awards expended are close to the $750,000 threshold). Therefore, the auditor needs to always inquire of the client about the need for a single audit and, if requested or necessary, assist the client in making the determination.

Single Audit and Major Program Determination Worksheet. To determine the need for a single audit, the auditor needs to obtain information about the amount of federal awards the client has expended during the year. While the responsibility for compiling a list of federal awards expended is the recipient's, the auditor is responsible for determining which of the programs and compliance requirements to test in accordance with the Uniform Guidance. The auditor should do the following:

- Determine major programs.
- Determine the programs for which tests of controls should be performed.
- Determine the programs that should be tested for compliance with federal statutes, regulations, and the terms and conditions of federal awards.
- Identify information for the schedule of expenditures of federal awards.

Grantor Agency Variations. Even if the entity does not expend enough ($750,000 or more) in federal awards to come under the audit requirements of the Uniform Guidance, it may be subject to other audit requirements. 2 CFR section 200.503 indicates that an audit under subpart F of the Uniform Guidance must be in lieu of any financial audit a nonfederal entity is required to undergo under any other federal statute or regulation. In addition, it states that "to the extent that such audit provides a Federal agency with the information it requires to carry out its responsibilities under Federal statute or regulation, a Federal agency must rely upon and use that information." However, the Uniform Guidance does not limit the authority of federal agencies, including their Inspector General (IG) or the U.S. Government Accountability Office (GAO), to conduct or arrange for additional audits (e.g., financial and performance audits, evaluations, inspections, or reviews). Also, the Uniform Guidance does not allow auditees to restrict the performance of additional audits by federal agencies. 2 CFR sections 200.503(b) and 200.503(d) require any additional audits to

be "planned and performed in such a way as to build upon work performed, including the audit documentation, sampling, and testing already performed, by other auditors," and for the full cost of funding the additional audits to be arranged by the federal agency that conducts or arranges for the additional audits.

The Single Audit Act Amendments and the Uniform Guidance discourage pass-through entities from requiring single audits of subrecipients with total federal awards expended of less than $750,000 annually by prohibiting the cost of such audits from being charged to the program (i.e., cannot be paid with federal funds). Note that the Single Audit Act Amendments and the Uniform Guidance do not prohibit charging federal awards for certain limited scope audits and other subrecipient monitoring procedures. 2 CFR section 200.425(c) specifically states "pass-through entities may charge Federal awards for the cost of agreed-upon-procedures engagements to monitor subrecipients . . . who are exempted from the requirements of the Single Audit Act and Subpart F—Audit Requirements of this part." However, such costs are allowable only if the agreed-upon-procedures engagements are:

a. Conducted in accordance with the Yellow Book's attestation standards;

b. Paid for and arranged by the pass-through entity; and

c. Limited in scope to one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; and reporting.

Federal agencies may also request that a program be audited as a major program in lieu of the agency conducting or arranging for additional audits. If the program would not have otherwise been audited as a major program, and the requesting agency agrees to pay the full incremental costs, the entity must have the program audited as a major program.

Auditor's Responsibility for Communication of Audit Requirements. AU-C 260.A13 explains that the auditor's responsibilities are often included in the engagement letter or other written agreement that documents the terms of the engagement. Providing those charged with governance with a copy of the engagement letter or other written agreement may be an appropriate way to convey the auditor's responsibility for communicating significant matters "that are, in the auditor's professional judgment, relevant to the responsibilities of those charged with governance in overseeing the financial reporting process."

The GAS/SA Audit Guide, Paragraph 3.61, indicates that it may be necessary to communicate with those charged with governance if the auditor becomes aware that the entity is subject to an audit requirement that is not encompassed in the terms of the engagement. Such communication would be appropriate when the auditor determines that an audit conducted in accordance with GAAS might not satisfy relevant legal, regulatory, or contractual requirements. This might be the case, for example, when an auditor who is engaged to perform an audit of the entity's financial statements in accordance with GAAS becomes aware that the entity also is required to have an audit performed in accordance with one or more of the following:

- *Government Auditing Standards*.
- The Uniform Guidance.
- Other compliance audit requirements, such as a federal agency's requirement for a program-specific audit or a state or local government requirement for a compliance audit.

The auditor's communication may be either written or oral. It is a best practice for the communication to be in writing so that the auditor will have documentation of the communication in case federal agencies take action against the client for not complying with audit requirements. As previously discussed, the Yellow Book suggests using the engagement letter to communicate matters related to the auditor's planned work and level of assurance to be provided in relation to the entity's compliance with laws, regulations, and provisions of contracts or grant agreement. If the auditor decides to communicate the audit requirements orally, the communication should be documented in the auditor's audit documentation. The auditor's report(s) may have to be reissued if the potential noncompliance with an audit requirement is discovered after the audit is completed and reports are issued. AU-C 935.43 provides guidance about when the auditor's report on compliance must be reissued. If the client decides not to comply with the audit requirements, the auditor should consider the potential effects of this decision on his or her report on the financial statements.

FEDERAL AWARDS EXPENDED

Basis for Determining the Amount of Federal Awards Expended

The criteria for determining the need for a single audit is expressed in terms of *federal awards expended*. In some cases, *awards expended* requires interpretation. 2 CFR section 200.502(a) states "the determination of when an award is expended must be based on when the activity related to the Federal award occurs." The activity usually relates to events that require the entity to comply with federal statutes, regulations, and the terms and conditions of federal awards, including:

a. Expenditure/expense transactions associated with awards, including grants, cost-reimbursement contracts under the FAR, compacts with Indian tribes, cooperative agreements, and direct appropriations.

b. Disbursement of pass-through funds to subrecipients.

c. Use of loan proceeds under loan and loan guarantee programs.

d. Receipt of property, including surplus property.

e. Receipt or use of program income.

f. Distribution or use of food commodities.

g. Disbursement of amounts entitling the nonfederal entity to an interest subsidy.

h. Period when insurance is in force.

The following examples distinguish between determining federal awards "received" and "expended:"

- Some federal programs operate under cost reimbursement arrangements in which the entity bills the federal awarding agency for costs as incurred. An entity may have expended $750,000 or more in a fiscal year but may not have received the reimbursement. In such a case, the entity would have recorded over $750,000 in federal awards expended. In addition, the entity generally would also recognize a receivable and related revenue in that same year in accordance with GAAP. A single audit would be required for the year in which the federal awards were expended, even though no federal award cash had actually been received.

- Assume an entity has received and expended cash of $450,000 under Program A. Assume also that it has received cash of $200,000 under Program B for which it has expended $300,000 and is awaiting reimbursement for the additional $100,000. A single audit is required, even though receipts of cash total only $650,000 because the total awards expended under both programs are $750,000 ($450,000 + $200,000 + $100,000).

- Some programs provide for advance payments. Assume that under such a program an entity received cash of $750,000 a few days before the end of the fiscal year 20X1 and did not expend any of it or recognize any revenue until early in fiscal year 20X2. Because there were no federal awards expended in 20X1, a single audit would not be necessary for 20X1 when the cash was received. If federal awards expended are $750,000 or more in 20X2, a single audit would be required for 20X2. Under GAAP, revenue would not generally be recognized until the expenditure of funds occurred (i.e., in 20X2).

The case studies later in this lesson also illustrate some of these concepts.

In determining the amount of federal awards expended, the following points would also be considered:

- The computation uses year-end adjusted balances for the entire reporting entity, subject to the requirements of the Uniform Guidance. That is, when the reporting entity is a governmental unit, the same

primary government and component units that are included in the government's basic financial statements are used in the computations. However, when the component unit has a separate single audit, federal awards expended by the component unit do not have to be included in the oversight unit's federal awards expended (or schedule of expenditures of federal awards), except to reflect any pass-through awards from the oversight entity to the component unit.

If the reporting entity is a nonprofit organization, the computation uses year-end adjusted balances for the nonprofit organization and any related nonprofit entities that are consolidated in the financial statements, subject to the requirements of the Uniform Guidance. However, when the related entity has a separate single audit, federal awards expended by the related entity do not have to be included in the nonprofit organization's federal awards expended (or schedule of expenditures of federal awards), except to reflect any pass-through awards from the nonprofit organization to the related entity.

- Amounts received directly from a federal agency but passed through to subrecipients are included in total federal awards expended for determining the need for a single audit. Federal awards received indirectly from pass-through entities (e.g., the state or another governmental or nonprofit organization) are also counted. Pass-through entities are responsible for identifying the source of funds to subrecipients. When a subrecipient receives a combined pass-through award (i.e., a state agency passes through federal funds to a local government and combines the award with state funds) and is unable to determine the amount of the award that is federal, the full amount of the award is treated as federal for purposes of determining the need for a single audit.

- When determining whether a single audit is required, expenditures of nonfederal matching funds are not considered to be federal awards expended. However, once it is determined that a single audit is required, the auditor performs audit procedures applicable to the matching funds.

- 2 CFR section 200.502(e) states "the cumulative balance of Federal awards for endowment funds that are federally restricted are considered awards expended in each audit period in which the funds are still restricted."

- It is best to accumulate amounts of federal awards expended by granting agency and program and/or for cluster of programs. A federal agency may sponsor several different programs (e.g., the Department of Education has bilingual education programs, vocational education programs, etc.). Also, an entity may receive several grants under a particular program, (i.e., several Headstart grants). The separate grants are aggregated to a total for that program, and the separate programs are aggregated by agency.

- Expenditures of Recovery Act awards are identified separately, even if they are included with a cluster of programs. Although separately identified, the expenditures would be aggregated with other expenditures for the same program or cluster of programs, if applicable, to determine total program expenditures.

- Section J, "Program Income," of Part 3.2 of the Compliance Supplement defines *program income* and indicates that program income may be used in one of three methods: deducted from total allowable costs, added to the federal award, or used to meet cost sharing or matching requirements. The type and method of using program income may result in a different assessment of whether program income is a component of federal awards expended (which may affect whether the single audit threshold is met) and the treatment of program income in the schedule of expenditures of federal awards. For example, if program income is added to the federal award, it would generally be included in federal awards expended on the schedule of expenditures of federal awards. The determination of program income is discussed in more detail later in this lesson.

Program Income. Section J of Part 3.2 of the Compliance Supplement (a link to the Compliance Supplement is included in *PPC's Government Documents Library* at Gov. Doc. No. 9) defines *program income* as "gross income earned by a non-Federal entity that is directly generated by a supported activity or earned as a result of the Federal award during the period of performance [unless there is a requirement for disposition of program income after the end of the period of performance as provided in 2 CFR section 200.307(f)]." 2 CFR section 200.307(f) states "there are no Federal requirements governing the disposition of income earned after the end of the period of performance for the Federal award, unless the Federal awarding agency regulations or the terms and conditions of the Federal

award provide otherwise. The Federal awarding agency may negotiate agreements with recipients regarding appropriate uses of income earned after the period of performance as part of the grant closeout process."

Examples of program income include income from—

- fees for services performed.
- the use or rental of real or personal property acquired under federal awards.
- the sale of commodities or items fabricated under a federal award.
- license fees and royalties on patents and copyrights, with certain exceptions.
- payments of principal and interest on loans made with federal award funds.

Section J does not limit program income to the items noted above. However, the Compliance Supplement does state that program income does *not* include—

- interest earned on advances of federal funds.
- rebates, credits, discounts, and interest earned on any of them (unless provided in federal statutes, regulations, or the terms and conditions of the federal award).
- taxes, special assessments, levies, fines, and other such revenues raised by a nonfederal entity (unless the federal award or federal awarding agency regulations specifically identify the revenues as program income).
- proceeds from the sale of equipment or real property acquired in whole or in part under the federal award.
- royalties or income earned by an institution of higher education or a nonprofit organization on inventions conceived or first actually reduced to practice in the performance of work under a funding agreement with a federal agency that is shared with the inventor.

Section J of Part 3.2 of the Compliance Supplement indicates program income may be used in one of three methods:

a. Deducted from total allowable costs.

b. Added to the federal award.

c. Used to meet cost sharing or matching requirements.

Program income must be deducted from total allowable costs if the federal awarding agency has given no prior approval for how program income is to be used and its regulations and the terms and conditions of the federal award are silent on this matter. However, for research and development activities by institutions of higher education and nonprofit research organizations, the default method is to add program income to the federal award (item b.). Program income may be used to meet the cost sharing or matching requirement of the federal award, if such use has prior approval of the federal awarding agency. Unless the agency regulations or the terms and conditions of the federal award specify otherwise, nonfederal entities have no obligation to the federal government regarding program income earned after the end of the period of performance.

Determining the Amount of Noncash Assistance Expended

When determining the amount of noncash federal assistance expended, 2 CFR section 200.502(g) states:

> Federal non-cash assistance, such as free rent, food commodities, donated property, or donated surplus property, must be valued at fair market value at the time of receipt or the assessed value provided by the Federal agency.

2 CFR section 200.502(f) indicates that when the *only* assistance received is in the form of free rent, a single audit is not required. However, in some cases, free rent may be received as part of an award to "carry out a Federal program." In these cases, *free rent* would fall under the definition of "other noncash assistance" and would be included in the total federal awards expended under the program when determining the need for a single audit.

Loans and Loan Guarantees. For federal awards that are in the form of other types of federal financial assistance (e.g., loans and loan guarantees), determining the amount of federal awards "expended," including the timing of when the award is considered "expended," is addressed in 2 CFR sections 200.502(b)–(d) and (j). When the entity receives this type of federal financial assistance, the auditor considers the following:

a. For loans and loan guarantees, because the federal government is at risk for loans until the debt is repaid, 2 CFR section 200.502(b) provides a formula that must be used to calculate the value of federal awards expended under loan programs. Except for the exceptions provided in b. and c. below, the value of federal awards expended under loan programs is equal to the sum of (1) the value of new loans made or received during the audit period, (2) the beginning of the audit period balance of loans from previous years for which the federal government imposes continuing compliance requirements, and (3) any interest subsidy, cash, or administrative cost allowance received.

b. For loans and loan guarantees (loans) at Institutions of Higher Education (IHE), when loans are made to students of an IHE but the IHE does not make the loans, only the value of loans made during the audit period must be considered federal awards expended in that audit period. The balance of loans for previous audit periods is not included as federal awards expended because the lender accounts for the prior balances.

c. Prior year loans and loan guarantees, the proceeds of which were received and expended in prior years, are not considered federal awards expended when the federal statutes, regulations, and the terms and conditions of federal awards pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

d. As previously discussed, certain loans provided by the National Credit Union Administration (NCUA) are not considered federal awards expended under 2 CFR section 200.502(j), which states "loans made from the National Credit Union Share Insurance Fund and the Central Liquidity Facility that are funded by contributions from insured nonfederal institutions are not considered federal awards expended."

Exhibit 1-3 shows the bases identified in 2 CFR section 200.502 used to determine the amounts of certain types of federal financial assistance expended.

Exhibit 1-3

Guidelines for Determining Amounts of Federal Financial Assistance Expended

Types of Federal Financial Assistance	Basis Used to Determine the Value of Federal Awards Expended
Loans and loan guarantees (loans), including interest subsidies[a]	Amount expended equals the value of new loans made or received during the audit period plus the beginning of the audit period balance of loans from previous years for which the federal government imposes continuing compliance requirements, plus any interest subsidy, cash, or administrative cost allowance received.
Loans at institutions of higher education[a]	Amount expended is the same as for loans and loan guarantees (loans), including interest subsidies (see above), except that when loans are made to students but the institution of higher education does not make the loans, only the value of loans made during the audit period must be considered federal awards expended in that audit period. The balance of loans for previous audit periods is not included as federal awards expended because the lender accounts for the prior balances.

Types of Federal Financial Assistance	Basis Used to Determine the Value of Federal Awards Expended
Insurance	Amount expended equals the fair value off the insurance contract at the time of receipt, or the assessed value provided by the federal agency.
Endowments	Amount expended equals the cumulative balance of federal awards for endowment funds that are federally restricted in each audit period in which the funds are still restricted.
Free rent	Amount expended equals the fair value of free rent at the time of receipt, or the assessed value provided by the federal agency. Free rent is not considered an award expended unless it is received as part of an award to carry out a federal program.
Food commodities, and donated property (including donated surplus property)	Amount expended equals the fair market value at the time of receipt, or the assessed value provided by the federal agency.

[SOURCE:Adapted from the AICPA Audit Guide, *Government Auditing Standards and Single Audits*, Table 7-2.]

Note:

[a] The proceeds of loans that were received and expended in prior audit periods are not considered federal awards expended when the federal statutes, regulations, and the terms and conditions of federal awards pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

* * *

Continuing Compliance Requirements. As noted in Paragraph 7.34 of the GAS/SA Audit Guide, the term *continuing compliance requirements* is not defined in the Uniform Guidance. OMB staff have informally indicated that—

- Continuing compliance requirements are loan provisions that require ongoing compliance.
- When evaluating whether requirements are continuing compliance requirements, auditors should consider whether any of the provisions or requirements are similar to the 12 compliance requirements included in Part 3 of the Compliance Supplement.

For example, as indicated previously, simply requiring that loans be repaid would not be considered a continuing compliance requirement. Repayment of the loan is a legal requirement monitored by the lender rather than a compliance requirement. However, provisions stipulating sinking or reserve funds, financial statements, auditor attestations, etc. would generally be considered continuing compliance requirements. Sinking and reserve fund requirements are similar to special tests and provisions requirements. Requirements that include submission of auditor attestations, financial statements, or other reports are related to the reporting compliance requirement.

Paragraph 7.34 of the GAS/SA Audit Guide indicates that it may not be necessary to include the loan balance in determining the total amount of loans expended if the only current year activity relating to a federal loan to construct a building consists of loan payments and a lender requirement to submit a report detailing loan payment information. However, if the lender requires the auditee to ensure on an ongoing basis that a certain percentage of the building is rented to low-income tenants, "it would likely be necessary" to include the loan balance when determining total loans expended.

Paragraph 7.34 of the GAS/SA Audit Guide states that "auditors may use professional judgment in evaluating the auditee's determination of whether continuing compliance requirements are significant enough to require inclusion

of prior-year loan or loan guarantee balances." The GAS/SA Guide indicates that if there is any question about the auditee's determination of whether continuing compliance requirements are significant enough to require inclusion of prior loan balances or loan guarantees, it may be appropriate to contact the federal agency's Office of Inspector General or another program contact listed in Appendix III of the Compliance Supplement. Auditors should document any such discussions in the workpapers.

Annual Determination

Determining the amount of federal awards expended and the audit period in which the award is "expended" is particularly important for entities for which single audits may not be required each year. For example, an entity may meet the threshold requiring a single audit in one year but not in the next. For this reason, it is important that the auditor carefully determine the amount of federal awards expended and the audit period in which the award is "expended."

FREQUENCY OF THE AUDIT AND THE AUDIT PERIOD

Frequency of the Audit

The Single Audit Act Amendments and 2 CFR section 200.504 require that audits be performed annually for the operations of the entity's fiscal year. However, there are the following two exceptions to the annual audit requirement:

- A state, local government, or Indian tribe that is *required* by constitution or statute, in effect on January 1, 1987, to have audits less frequently than annually, is permitted to have biennial audits. This requirement must still be in effect for the biennial period.

- Nonprofit organizations that had biennial audits for *all* biennial periods ending between July 1, 1992, and January 1, 1995, are permitted to have biennial audits.

Any biennial audit must cover both years within the biennial period.

Period to Be Included

The single audit must cover the entity's fiscal year, not the award year or period of the program being funded. If the single audit is performed on a biennial basis, the single audit must cover both years.

Period to Be Included—Program-specific Audits

2 CFR section 200.507(d) indicates that the requirements relating to frequency of audits and audit period also apply to program-specific audits unless they contradict the provisions of 2 CFR section 200.507, the applicable program-specific audit guide, or program statutes and regulations. Under the Uniform Guidance, audits must generally be performed annually and cover the entity's fiscal year. The Uniform Guidance does not explicitly address whether a program-specific audit may be performed on a program-year basis if the applicable program-specific audit guide, or program statutes and regulations do not *require* an audit on that basis. It seems logical that the audit period may be considered the fiscal period (annual or biennial) of the entity being audited or the program or award period, providing that the financial statements and schedule of expenditures of federal awards are prepared on the applicable basis. If a period other than the fiscal period of the entity is to be used, the authors suggest the period be discussed with the federal or pass-through agency until further guidance is made available.

Stub Periods

When an entity (a) has a program-specific audit (sometimes performed on a program-year basis) in one year and a single audit (performed on a fiscal-year basis) in the next year, or (b) changes audit periods, a situation may arise where a period of time is not included in either audit. This period of time between the end of the fiscal year and the beginning of the program year is referred to as a *stub period*. Although the Uniform Guidance does not contain a provision allowing an audit of the stub period, this issue is addressed in the GAS/SA Audit Guide. Paragraph 6.17 of the GAS/SA Audit Guide indicates that when confronted with a stub period, the entity should make arrangements

to meet the audit requirements for federal expenditures during the stub period. The auditor may either perform a separate audit of the stub period or include the stub period in the following period's audit. Regardless of which audit arrangement is chosen, the threshold is still $750,000 of federal expenditures for the period. As discussed above, if a period other than the fiscal period of the entity is to be used, the authors suggest the entity consult with the funding agency.

SPECIAL PLANNING CONSIDERATIONS FOR INITIAL ENGAGEMENTS

Initial Audit of Unaudited Entity

Because of the nature of their operations and because nonprofit organizations and governmental units are not subject to SEC filing requirements, some entities will have their first audits when they fall within the requirements of the Uniform Guidance. When performing an initial audit of a previously unaudited entity, the auditor needs to discuss with the client and the cognizant or oversight agency for audit the need to perform any additional audit work for prior unaudited periods. *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Audits of Nonprofit Organizations* include detailed discussions of pertinent issues for initial audits of unaudited entities. Issues related to review of terminated contracts in initial single audit engagements are discussed in the following paragraph.

Review of Terminated Contracts. When performing an initial single audit engagement, the auditor is particularly concerned with the possibility that there may be liabilities related to terminated contracts and award programs. The auditor may wish to review terminated federal awards to determine compliance with the terms and conditions of the award and to identify any potential liabilities or uncollectible receivables resulting from final closeout of the awards. The auditor may also wish to communicate with the entity's cognizant or oversight agency for audit to confirm these matters.

Replacing Predecessor Auditors

If the entity has had a predecessor auditor or has employed independent governmental auditors who have expressed an opinion on the preceding period's financial statements, the successor auditor can usually save time and expense by reviewing the predecessor's workpapers. This review is only one of several sources of audit evidence that can be used in assessing the impact of beginning balances on the current year financial statements. Other evidence on beginning balances may include the most recent audited financial statements and the auditor's report thereon, the results of inquiries of the predecessor auditor, the results of the successor auditor's review of the predecessor's workpapers, and audit procedures performed on the current year's transactions. *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Audits of Nonprofit Organizations* include detailed discussions concerning replacing predecessor auditors and reaudit situations. Information that should be assessed when determining major programs is discussed later in this lesson.

The GAS/SA Audit Guide, Paragraph 16.18, states that before accepting an initial audit engagement (including a re-audit engagement), the auditor should ask management to authorize the predecessor auditor to respond fully to the auditor's inquiries about matters that will assist the auditor in determining whether to accept the engagement. If management refuses to authorize the predecessor auditor to respond, or limits the response, the auditor should inquire about the reasons and consider the implications of that refusal in deciding whether to accept the engagement.

Special Considerations—Risk-based Approach Factors to Consider in a First Year Audit

Paragraph 6.19 of the GAS/SA Audit Guide explains that auditors accepting, or considering accepting, a Uniform Guidance compliance audit engagement might consider requesting information such as the following:

- Amount of federal awards expended (by federal program).
- Prior-period findings and questioned costs (including the auditee's corrective action plan, summary schedule of prior audit findings, and any management decisions issued by the federal awarding agency or pass-through entity related to audit findings).

- Correspondence from program officials indicating potential problems.
- New programs or changes to existing programs.
- Amount of funding passed through to subrecipients (by individual federal program).
- Federal programs audited as major programs for the last two years.

A CASE STUDY TO ILLUSTRATE PRE-ENGAGEMENT ACTIVITIES

Determining the Need for a Single Audit for a Governmental Unit

The auditor has been asked by the Willow County Commissioners to help them determine if the county needs to have a single audit. The auditor learns the following:

- During the current year, the county received and recorded as revenue a $430,000 grant from the U.S. Department of Transportation to study the need for additional traffic signals in the county. All of the grant was expended in the current year.
- One of the component units of the county, a water conservation district, received and recorded as revenue a $210,000 grant from the Environmental Protection Agency to improve the district's planning function. All of the grant was expended in the current year.
- The county school district, also considered a component unit of the county, received cheese and milk from the U.S. Department of Agriculture for school meals. The estimated value of the commodities received (and used) was $125,000, and revenue and expenditures of that amount were recorded.
- The county has no loans outstanding from any federal agency.
- The county's component units do not have separate single audits.

The auditor concludes that the county will need a single audit because it has a total of $765,000 in federal awards expended:

Cash grant from Department of Transportation	$ 430,000
Cash grant from Environmental Protection Agency	210,000
Value of commodities received from Department of Agriculture	125,000
	$ 765,000

Governmental or nonprofit organizations that expend $750,000 or more in a year in federal awards must have either a single or program-specific audit performed for that year in accordance with the Uniform Guidance. The term *federal awards expended* includes expenditure of both cash and noncash assistance. Thus, the estimated value of the cheese and milk must be counted in determining total federal awards expended. Amounts of awards expended by component units of the county (i.e., the water conservation district and the county school district) must be considered when determining the need for a single audit. This is because the Uniform Guidance requires the audit to cover the entire operations of the auditee. However, if the component unit(s) had a separate single audit, federal awards expended by the component unit(s) would not have to be included in the county's federal awards expended, except to reflect any pass-through awards from the county to the component unit(s).

2 CFR section 200.514(a) also provides, however, that:

> . . . at the option of the auditee, such audit must include a series of audits that cover departments, agencies, and other organizational units that expended or otherwise administered Federal awards during such audit period, provided that each such audit must encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and other organizational unit, which must be considered to be a non-Federal entity.

Thus, the county can either arrange for a single audit of the entire financial reporting entity or a series of audits of the administration of the Department of Transportation's grant and the two component units expending federal awards.

In some cases, a series of single audits may be desirable. For example, if several very large component units did not expend any federal awards and an audit of the financial statements of these units is not otherwise necessary, then it may be less costly to avoid an entity-wide single audit. In other cases, an entity-wide single audit may be desirable. For example, a series of single audits may involve lower materiality levels and, therefore, greater audit costs. In this case, if a series of audits were performed, internal control used to administer the Department of Transportation grant and the Environmental Protection Agency grant would need to be tested. Also, the financial statements of these units would need to be audited and reported on along with the report on compliance and other reports. Finally, if the county is required by law to obtain an audit of its basic financial statements, a series of audits would probably be more costly. The auditor advises the client of these considerations to help them decide how to meet the single audit requirements.

Determining the Need for a Single Audit for a Nonprofit Organization

The auditor has been asked by Riverside Community Centers, Inc., to help determine if it is required to have a single audit. Through discussions with management and review of accounting records and financial statements, the auditor learns the following:

- Riverside Community Centers, Inc. (Riverside) is a voluntary health and welfare organization that operates four community centers, a community clinic, and four outreach offices, all of which operate as branches. The branches all provide social services to needy residents of Tarrant County, Texas. In addition, the organization has created a related organization, ABC Shelter Association, Inc. (ABC), which operates three shelters within Tarrant County. ABC, which is consolidated into Riverside's GAAP financial statements, is controlled by Riverside's board of directors. In addition, ABC receives federal funding through Riverside.

- During the current year, ABC received $425,000 under a Food and Shelter Program sponsored by the Federal Emergency Management Agency (FEMA). All of the $425,000 was expended and recognized as revenue in the current year.

- During the current year, one of Riverside's branches received a grant amounting to $370,000 from the State of Texas. Included in the $370,000 was $70,000 in state funds and $300,000 that had been awarded to the State by the U.S. Department of Health and Human Services (HHS) and passed through to Riverside. All of the grant was expended and recognized as revenue in the current year.

- The Department of Housing and Urban Development (HUD) has insured a loan for Riverside. The loan balance at the beginning of the audit period was $125,000. The loan was made for the purpose of purchasing equipment for Riverside's medical clinic. The loan contains continuing compliance requirements.

The auditor concludes that Riverside and its consolidated related organization, ABC, will need a single audit because the reporting entity in total has expended a total of $850,000 in federal awards:

Cash grant awarded to ABC by FEMA	$ 425,000
HHS grant passed through to branch by the State of Texas	300,000
Beginning of period balance of loan that is insured by HUD	125,000
	$ 850,000

The Uniform Guidance requires the audit to cover the entire operations of the auditee, including certain related organizations for nonprofit entities. This means that Riverside and all of its branches must be included in the calculation when determining the need for a single audit. In addition, because ABC does not appear to be independent for reporting under GAAP (consolidated with Riverside, no separate financial statements of ABC issued), ABC must also be considered when determining the need for a single audit, and a $425,000 grant awarded to ABC by FEMA must be included in the above calculation.

When considering the $370,000 grant that was received from the state of Texas, the $70,000 in state funds received and expended should not be considered. Only the $300,000 that represents expenditures of funds from HHS should be included in the calculation. It should be noted, however, that even though the $70,000 expended in state funds should not be included when determining the need for a single audit, the state might impose on the organization various audit requirements, including the need for a Uniform Guidance audit. It should also be noted that the state, through the grant contract, may require its financial awards to be treated the same as federal funds for audit purposes. However, additional audits must be paid for by the requesting agency.

Because certain other types of federal financial assistance (e.g., loans and loan guarantees) are is included in the definition of federal awards expended, the $125,000 loan that is insured by HUD must also be included when determining federal awards expended. According to 2 CFR section 200.502(b), the balance of the loan at the beginning of the audit period in Riverside's financial statements is the amount that should be used in the calculation. Table 17-2 of the GAS/SA Audit Guide provides similar guidance.

Based on the information in this case study and the guidance relating to audit scope provided earlier in this lesson, the single audit would include both Riverside and ABC, since ABC is included in Riverside's consolidated 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.

11. Which of the following statements best describes an engagement letter?

    a. It may be appropriate to consult legal counsel when drafting an engagement letter.

    b. The Yellow Book's information on engagement letters is less detailed than AU-C 210.

    c. It is appropriate to include indemnification clauses to protect the client.

    d. The financial statements and the application of accounting policies should be listed under the auditor's responsibilities.

12. Which of the following applies when determining whether a client needs a single audit?

    a. Receiving federal awards requires an entity to undergo a single audit.

    b. The focus is on separate awards when determining if a program-specific audit can be used.

    c. Clients will typically know if they need a single audit before engaging an auditor.

    d. A cluster of programs is treated as one program for the determination of major programs.

13. Income from which of the following would be considered *program income*?

    a. Rebates, credits, and discounts.

    b. Proceeds from the sale of real estate.

    c. Royalties earned on an invention.

    d. Fees for services that were performed.

14. The government of Blueville had a program-specific audit one year and a single audit the next. Which of the following may occur?

    a. A biennial audit period.

    b. A stub period.

    c. The applicable threshold amount for a single audit is lowered.

    d. An audit over the award year.

15. Which of the following pieces of information might be helpful in a first year Uniform Guidance compliance audit?

    a. Federal programs considered major programs for the last five years.

    b. Loan provisions that require ongoing compliance.

    c. Any changes to existing programs or new programs added this year.

    d. The method used to account for program income.

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. Which of the following statements best describes an engagement letter? **(Page 199)**

    a. It may be appropriate to consult legal counsel when drafting an engagement letter. [This answer is correct. Because the engagement letter is essentially a service contract, some auditors consult their attorneys when drafting it.]

    b. The Yellow Book's information on engagement letters is less detailed than AU-C 210. [This answer is incorrect. The Yellow Book *broadens* the parties that receive the auditor's communication and also specifies additional items to be communicated. Therefore, it expands the guidance in AU-C 210 rather than providing less guidance.]

    c. It is appropriate to include indemnification clauses to protect the client. [This answer is incorrect. In some instances, entities have issued RFPs or asked auditors to sign contracts containing clauses indemnifying the client against damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to the attest client's acts. Because such clauses are often included in RFPs and proposed audit contracts, auditors should carefully review those documents to ensure they are not agreeing to such provisions. ET 1.228.020 states that such an agreement would impair the auditor's independence. On the other hand, according to ET 1.228.101, the engagement letter may include a clause that provides that the attest client would release, indemnify, defend, and hold the covered member harmless from any liability and costs resulting from known misrepresentations by management. Such a clause would not impair the auditor's independence.]

    d. The financial statements and the application of accounting policies should be listed under the auditor's responsibilities. [This answer is incorrect. Management is responsible for certain items, including the financial statements and the selection and application of accounting policies. Therefore, this should be listed in the engagement letter under management's responsibilities, not the auditor's responsibilities.]

12. Which of the following applies when determining whether a client needs a single audit? **(Page 207)**

    a. Receiving federal awards requires an entity to undergo a single audit. [This answer is incorrect. The Uniform Guidance does not require every recipient of federal awards to have a single audit, but only those expending a specified amount of federal awards.]

    b. The focus is on separate awards when determining if a program-specific audit can be used. [This answer is incorrect. Auditors should focus on *programs*, not separate awards, when determining major programs or assessing whether a program-specific audit may be elected. The Uniform Guidance broadens the definition of programs to address a "cluster of programs."]

    c. Clients will typically know if they need a single audit before engaging an auditor. [This answer is incorrect. When proposing or planning for an engagement for an audit of financial statements, it is important that the auditor determine whether a single audit is required. The client may know that it needs a single audit at the time it engages the auditor. Some clients, however, may not be aware of these requirements. Others may be unsure because they are borderline cases. Therefore, the auditor needs to always inquire of the client about the need for a single audit and, if requested or necessary, assist the client in making the determination.]

    d. A cluster of programs is treated as one program for the determination of major programs. [This answer is correct. 2 CFR section Page 153.17 defines *cluster of programs* as ". . . a grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development (R&D), student financial aid (SFA), and other clusters." This guidance also states that a cluster of programs must be considered as one program when determining major programs and, with the exception of R&D, whether a program-specific audit may be elected.]

13. Income from which of the following would be considered *program income*? **(Page 211)**

    a. Rebates, credits, and discounts. [This answer is incorrect. The Compliance Supplement states that rebates, credits, discounts, and interest earned on any of them (unless provided in federal statutes, regulations, or the terms and conditions of the federal award) will *not* be included in program income.]

    b. Proceeds from the sale of real estate. [This answer is incorrect. Proceeds from the sale of equipment or real property acquired in whole or in part under the federal award are specifically *not* included in program income, per the Compliance Supplement.]

    c. Royalties earned on an invention. [This answer is incorrect. According to the Compliance Supplement, royalties or income earned by an institution of higher education or a nonprofit organization on inventions conceived or first actually reduced to practice in the performance of work under a funding agreement with a federal agency that is shared with the inventor are *not* considered program income.]

    d. Fees for services that were performed. [This answer is correct. Section J of Part 3.2 of the Compliance Supplement defines *program income* as "gross income earned by a non-Federal entity that is directly generated by a supported activity or earned as a result of the Federal award during the period of performance." Examples of program income include income from fees for services performed, the use or rental of real or personal property acquired under federal awards, or the sale of commodities or items fabricated under a federal award.]

14. The government of Blueville had a program-specific audit one year and a single audit the next. Which of the following may occur? **(Page 214)**

    a. A biennial audit period. [This answer is incorrect. A biennial audit period only occurs when an exception to the annual audit requirement occurs, such as if a state, local government, or Indian tribe that is *required* by constitution or statute, in effect on January 1, 1987, to have audits less frequently than annually.]

    b. A stub period. [This answer is correct. When an entity (1) has a program-specific audit (sometimes performed on a program-year basis) in one year and a single audit (performed on a fiscal-year basis) in the next year or (2) changes audit periods, a situation may arise where a period of time is not included in either audit. The period of time between the end of the fiscal year and the beginning of the program year is referred to as a *stub period*.]

    c. The applicable threshold amount for a single audit is lowered. [This answer is incorrect. Regardless of the audit arrangement chosen, the threshold of federal award expenditures for the period will stay the same.]

    d. An audit over the award year. [This answer is incorrect. Single audits cover the entity's fiscal year, not the award year or period of the program being funded.]

15. Which of the following pieces of information might be helpful in a first year Uniform Guidance compliance audit? **(Page 215)**

    a. Federal programs considered major programs for the last five years. [This answer is incorrect. According to the GAS/SA Audit Guide, the auditor might consider requesting federal programs audited as major programs for the last *two* years.]

    b. Loan provisions that require ongoing compliance. [This answer is incorrect. According to OMB staff, continuing compliance requirements are loan provisions that require ongoing compliance. However, this information is pertinent more to loans and loan guarantees than to initial engagements.]

    c. Any changes to existing programs or new programs added this year. [This answer is correct. Paragraph 6.19 of the GAS/SA Audit Guide explains that auditors accepting, or considering accepting, a Uniform Guidance compliance audit engagement might consider requesting certain information, such as the amount of federal awards expended (by federal program), correspondence from program officials indicating potential problems, and new programs or changes to existing programs.]

    d. The method used to account for program income. [This answer is incorrect. How program income is used is discussed in Section J of Part 3.2 of the Compliance Supplement; however, this consideration is not specific related to initial engagements.]

Lesson 2: Internal Control Considerations

INTRODUCTION

Consideration of the audit strategy for internal control is an important element of planning and performing audits of state and local governments, nonprofit organizations, and other recipients of government assistance. The strategy takes on an even greater importance when the Uniform Guidance applies.

This lesson covers the significant aspects of internal control considerations as they relate to the procedures required and performed as part of a single audit in accordance with the Uniform Guidance and to the audit of the financial statements. More information on internal control can also be found in *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Audits of Nonprofit Organizations*.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify what an auditor must do to obtain an understanding of a governmental entity's internal control.
- Determine responsibilities for internal control in all audits, additional responsibilities for single audits, what controls should be tested, how to perform tests of the operating effectiveness of controls, and how to report responsibilities.

Authoritative Literature

The authoritative pronouncements that are relevant to an audit conducted in accordance with the Uniform Guidance include both general pronouncements that are relevant to the study and evaluation of internal control and pronouncements that are specific to governmental and nonprofit engagements and to the single audit.

Auditors should have a thorough working knowledge of the following pronouncements and other guidance:

- AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.
- AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.
- AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.
- AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.
- AU-C 935, *Compliance Audits*.
- AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide).

Congress, the Government Accountability Office (GAO), and the Office of Management and Budget (OMB) have issued the following regulations and publications that are relevant to requirements for testing and reporting on internal control:

- Single Audit Act Amendments of 1996 (included in *PPC's Government Documents Library* at Gov. Doc. No. 1).
- Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). [The most current version of 2 CFR part 200 is in the Electronic Code of Federal Regulations (eCFR) at **www.ecfr.gov**/**cgi-bin**/**text-idx?tpl**=/**ecfrbrowse**/**Title02**/**2cfr200_main_02.tpl**.]

- GAO *Government Auditing Standards* (Yellow Book) (a link to the Yellow Book is included in *PPC's Government Documents Library* at Gov. Doc. No. 2).

- *OMB Compliance Supplement* (Compliance Supplement) (a link to the Compliance Supplement is included in *PPC's Government Documents Library* at Gov. Doc. No. 9).

Uniform Guidance. OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance), requires nonfederal entities to establish and maintain effective internal control over federal awards that provides reasonable assurance that the awards are being managed in compliance with federal statutes, regulations, and the terms and conditions of the federal award. 2 CFR section 200.303 states that the internal controls should be in compliance with guidance in *Standards for Internal Control in the Federal Government* (the "Green Book") or with *COSO's Internal Control—Integrated Framework* (COSO Framework). The GAS/SA Audit Guide, Paragraph 9.65, clarifies that there is no expectation or requirement for (a) an entity to document or evaluate internal controls prescriptively in accordance with the Green Book or the COSO Framework or (b) the entity or its auditor to reconcile technical differences between them. Nonfederal entities and their auditors will need to exercise judgment in determining the most appropriate and cost effective internal control in a given environment or circumstance.

Part 6 of the 2017 Compliance Supplement addresses the objectives, principles, and components of internal control based on the Green Book and COSO Framework.

As part of its system of internal control, a nonfederal entity must take reasonable measures to safeguard protected personally identifiable information and other information the federal awarding agency or pass-through entity designates as sensitive or that the nonfederal entity considers sensitive consistent with applicable federal, state, and local laws on privacy and obligations for confidentiality. 2 CFR section 200.79 defines *personally identifiable information* (PII) as:

> Information that can be used to distinguish or trace an individual's identity, either alone or when combined with other personal or identifying information that is linked or linkable to a specific individual. Some information that is considered to be PII is available in public sources such as telephone books, public Web sites, and university listings. This type of information is considered to be Public PII and includes, for example, first and last name, address, work telephone number, email address, home telephone number, and general educational credentials. The definition of PII is not anchored to any single category of information or technology. Rather, it requires a case-by-case assessment of the specific risk that an individual can be identified. Non-PII can become PII whenever additional information is made publicly available, in any medium and from any source, that, when combined with other available information, could be used to identify an individual.

Audit guidance in Paragraph 9.66 of the GAS/SA Audit Guide explains that nonfederal entities may have changed or updated their internal controls over compliance to a greater extent than normal in the process of implementing the Uniform Guidance. The auditor should consider those changes when obtaining an understanding of internal control over compliance, assessing risk, and testing controls. In addition, the results of prior years' internal control tests might not be relevant to tests of internal control when planning the current year's audit. Furthermore, separate samples may be necessary if internal control has changed significantly or if controls over transactions that are subject to the Uniform Guidance administrative requirements and cost principles are different than controls over transactions that are subject to the previous administrative requirements and cost principles.

THE AUDITOR'S UNDERSTANDING OF INTERNAL CONTROL

This section provides an overview of the general requirements of GAAS and *Government Auditing Standards* as they relate to obtaining an understanding of internal control. AU-C 315.13–.25 establishes requirements for auditors related to consideration of internal control as part of an audit. It also provides guidance about how the entity's use of information technology (IT) affects the auditor's consideration in planning the audit. The auditor's responsibilities for considering internal control in all audits and additional responsibilities for single audits are discussed later in this lesson.

The auditor's consideration of internal control over compliance for federal award programs in a Uniform Guidance audit of compliance is similar to the consideration of internal control over financial reporting in a financial statement audit. The same concepts apply regarding assessing risk, understanding internal control over compliance, and testing controls. However, the consideration of internal control in a Uniform Guidance audit of compliance is directed toward the internal control objectives related to compliance with federal statutes, regulations, and the terms and conditions of federal awards.

Components of Internal Control

AU-C 315.15–.25 requires an understanding of five interrelated components of internal control defined and described in more detail in COSO's *Internal Control—Integrated Framework*. The five components are as follows:

- Control environment
- Risk assessment
- Information and communication
- Monitoring
- Control activities

The requirement to obtain an understanding of the five components of internal control is applicable in both an audit of the financial statements and a Uniform Guidance audit of compliance. One of the significant findings stated in the Report on the National Single Audit Sampling Project was a failure by auditors to identify and test all five components of internal control for each direct and material compliance requirement for each major program.

In assessing risk to develop an overall audit strategy for either an audit of the financial statements or an audit of compliance, auditors generally focus on obtaining an understanding of the control environment, risk assessment, information and communication, and monitoring components, typically obtaining an understanding of the control environment first. The understanding of control activities is not needed until planning the nature, timing, and extent of further audit procedures. As a practical matter, however, auditors often obtain an understanding of control activities while obtaining an understanding of the other control components. More in-depth discussions about each element of internal control can be found in *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Audits of Nonprofit Organizations*.

Although smaller entities may not have formally adopted, or even be familiar with the COSO Framework, it is a best practice for auditors to use the COSO Framework as a reference and guide for understanding and evaluating internal control as it relates to their clients. Since the issuance of the original COSO internal control framework in 1992 (1992 Framework), there have been dramatic changes in operating environments, making entities more complex and technologically driven. In May 2013, COSO issued an updated *Internal Control—Integrated Framework* (2013 Framework) to help entities design, implement, and evaluate internal control in light of the current operating and regulatory environments. While similar to the 1992 Framework in many ways, the 2013 Framework enhances and clarifies a number of its concepts to make the Framework easier to use and apply. For example, fundamental concepts in the 2013 Framework are expressed as principles. The 2013 Framework articulates 17 principles, which are associated with the five components of internal control. Each principle has several underlying points of focus for evaluating the principle. Concurrently with the 2013 Framework, COSO issued several related documents that provide tools, approaches, and examples to assist entities when designing, implementing, and assessing effectiveness of a system of internal control.

Nature of the Auditors' Understanding

AU-C 315.13–.14 requires auditors to obtain an understanding of internal control that is sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures. In addition to being required to assess the risk of material misstatement of the financial statements 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 of federal awards due to noncompliance. Auditors should

perform risk assessment procedures to (a) evaluate the design of controls that are relevant to the audit and (b) determine if they have been implemented. A key consideration is whether and how a particular control prevents, or detects and corrects, material misstatements in relevant assertions related to transactions, account balances, or disclosures, or noncompliance.

Evaluation of *design* considers whether the control, individually or in combination with other controls, is capable of effectively detecting or correcting material misstatements or instances of noncompliance. In other words, the auditor considers the effectiveness of the control in achieving its objective. If a control is improperly designed, it may represent a control deficiency that needs to be communicated to management and those charged with governance.

It is not enough to simply determine whether a control as described or documented appears to be effective in design. Many sophisticated entities have extensive policies and procedures manuals that provide intricate descriptions of controls, their objectives, and the procedures that are supposed to be followed to achieve the objective. The documentation of a control procedure, however, does not demonstrate that the control is actually operating as intended. The auditor, therefore, also needs to determine if the control, as documented or described, actually exists and the entity is using it. In other words, the auditor uses risk assessment procedures to obtain audit evidence that the control has actually been implemented. Determining whether a control has been implemented confirms the auditor's understanding of control design and helps ensure that the risk assessment is based on accurate information. Generally, the auditor uses procedures such as observation or inspection, in combination with inquiries, to verify implementation. According to AU-C 315.14, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry. In other words, inquiry alone cannot provide a sufficient understanding of internal control.

In a Uniform Guidance audit of compliance, the auditor performs risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls over federal awards. The GAS/SA Audit Guide, Paragraph 9.19, states, "for each of the programs and direct and material compliance requirements selected for testing, the auditor should perform risk assessment procedures to obtain a sufficient understanding of the direct and material compliance requirements and the entity's internal control over compliance with those compliance requirements." It further explains that the auditor might perform procedures such as inquiring of entity personnel, observing the application of a specific control, and inspecting documents and reports. It reiterates that inquiry alone is not sufficient to evaluate the design of a control and to determine whether it has been implemented.

Extent of the Auditors' Understanding

The overriding criterion regarding the understanding of internal control is that it be sufficient to assess the risk of material misstatement of the financial statements due to error or fraud, including misstatements caused by noncompliance, and to design the nature, timing, and extent of further audit procedures. In a single audit, this requirement also applies to the auditor's understanding of internal control over preparation of the schedule of expenditures of federal awards and program financial reports, as well as internal control over compliance. A discussion of the auditor's responsibilities related to internal control in a Uniform Guidance audit of compliance is beyond the scope of this course, but more information is available in *PPC's Guide to Single Audits*. Obtaining an understanding that is sufficient to assess the risks of material misstatement or noncompliance necessitates that the auditor develop a fairly thorough and robust knowledge of the components of internal control. AU-C 315.26–.27 indicates that to provide a basis for designing and performing audit procedures, the auditor should identify and assess the risks of material misstatement throughout the process of obtaining an understanding of the entity and its environment, including the relevant controls that relate to the risks. AU-C 935.15 extends the requirement to perform risk assessment procedures to a compliance audit.

Determining the Extent of the Understanding. The extent of the understanding of internal control that is sufficient is a matter of professional judgment. Generally, the extent of the auditor's understanding and the extent of the associated risk assessment procedures performed to obtain the understanding, are affected by factors such as the following:

- The auditor's prior experience with the client.
- Materiality.

- Significance of the related risk.
- Nature of the client's operations, including its organizational structure.
- Size of the entity.
- Diversity and complexity of operations.
- Nature and complexity of systems within the organization, including the use of service organizations.
- Nature of the governmental or nonprofit industry.
- Applicable legal and regulatory requirements.
- The nature of any compliance auditing requirements or special reporting requirements.
- Level of business and financial sophistication of the client.
- The circumstances and applicable control component.
- Whether and how a specific control, individually or in combination with other controls, prevents, or detects and corrects, material misstatements or material noncompliance.

Understanding Controls Related to Significant Risks

AU-C 315.30 indicates that the auditor's understanding of internal control should include the entity's programs and controls that address risks of material misstatement or noncompliance that are considered significant risks. SLG, Paragraph 4.61, indicates that when considering the nature of the risks, a number of matters need to be considered, including (a) whether the risk is related to fraud; (b) recent significant economic, accounting, or other developments; (c) the complexity of transactions; (d) whether it involves significant transactions with related parties; (e) the amount of subjectivity in the measurement of financial information related to the risk, especially measurements with a wide range of measurement uncertainty; and (f) whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

Programs and controls addressing fraud risks or other significant risks may relate to any of the five components of internal control; thus, the auditor needs to use care not to isolate the understanding to only the control activities component. The auditor ought to be alert to the fact that significant or fraud risks may not be subject to routine controls given the nature of the risks. Also, the auditor's understanding extends to whether and how management responds to those risks.

Using the Results of the Understanding of Internal Control

The understanding of internal control needs to be sufficient to assess the risks of material misstatement or noncompliance and to design the nature, timing, and extent of further audit procedures. Specifically, the understanding is used to:

- Identify types of potential material misstatements or noncompliance.
- Consider factors that affect the risks of material misstatement or noncompliance.
- Design tests of controls and substantive procedures.

In addition, the understanding provides audit evidence that contributes to the auditor's planned responses to assessed risks and the performance of further audit procedures. This evidence is an element of the auditor's cumulative audit evidence that ultimately supports the opinions on the financial statements and on federal award program compliance. The auditor remains alert for risks that may be identified during the process of obtaining an understanding of internal controls. Identified risks should be documented.

Normally, the auditor's understanding of internal control design and implementation does not provide sufficient evidence to reach a conclusion about the operating effectiveness of controls. Although the same types of procedures performed to determine if a control has been implemented (e.g., observation, inspection of documents, reperformance, and walkthroughs) are also used when testing controls, the extent of the procedures to determine implementation may fall short of what is needed to determine operating effectiveness because tests of operating effectiveness need to provide audit evidence about how controls were applied throughout the period under audit and the consistency with which they were applied. However, in some cases, the auditor's procedures may serve both purposes. For example, a walkthrough can serve as a test of controls and in some cases, along with other procedures that also serve as tests of controls, can provide a valid basis for assessing control risk at less than high. In addition, for an automated control where consistency of application would normally occur assuming the existence of effective IT general controls, the auditor may be able to determine operating effectiveness based on procedures performed to establish that the control has been implemented and the auditor's assessment and testing of the related general controls.

Considering Control Objectives/Principles and Key Controls

Control Objectives and Principles. When obtaining an understanding of internal control, many auditors consider *control objectives* during the process of identifying controls and evaluating their design and implementation. A *control objective* states the purpose of a control (or controls) in relation to risks and "what could go wrong." For example, "All grants receivable are correctly recorded," might be a control objective that addresses a risk of grants receivable not being properly tracked and recorded (i.e., completeness). Failure to achieve that control objective could potentially result in overstatement or understatement of grants receivable and related revenues.

The term *control objectives* in this course is commonly used in connection with controls relating to the account balance, transaction class, or disclosures, as well as general IT controls. For entity-level controls, such as control environment and monitoring controls, this course refers to principles instead of control objectives. This course also uses the term *control objectives* in connection with controls relating to compliance with federal statutes, regulations, and the terms and conditions of federal awards. By considering control objectives (and principles) and how they relate to risks and what can go wrong at the relevant assertion level, an auditor might find it easier to identify existing controls and evaluate their design effectiveness.

Key Controls. As indicated at AU-C 315.21, the auditor is not required to understand all controls and control activities that might exist in an entity. The auditor typically focuses attention on those controls that are most important in achieving particular control objectives (and principles) related to identified risks. Often, an entity has multiple controls that contribute to achieving its control objectives. However, certain of those controls, referred to as *key controls*, are considered primary to achieving the objective. When identifying controls, evaluating design effectiveness, determining implementation, and testing controls, it is often most efficient and effective for the auditor to focus on *key controls*. Many times, these are the controls that the client believes are the most effective and reliable in operation to fully address a control objective. When determining which controls are key, the auditor considers factors such as:

- The nature of the risks being addressed.
- The characteristics of related account balances or transaction classes.
- Whether the control is preventive (i.e., prevents misstatements or noncompliance) or detective (i.e., detects misstatements or noncompliance).
- Whether the control works in combination with or relies on the operation of other controls.
- Whether the control is manual or automated.
- Whether the control addresses more than one control objective.
- The nature and type of potential misstatements or noncompliance that the control would prevent, or detect and correct (i.e., would misstatements or noncompliance most likely arise from error, fraud, or misappropriation of assets?).

The GAS/SA Audit Guide uses a similar concept to determine which controls to test when sampling in a Uniform Guidance audit of compliance. Paragraph 11.61 of the GAS/SA Audit Guide uses the term *significant controls*. It states, "all controls that the auditor determines are to be tested to mitigate the risk of material noncompliance are significant controls, but a spectrum exists concerning the significance of each control."

Effect of Information Technology (IT) on Internal Control

AU-C 315 indicates that auditors should consider how IT affects an entity's control activities. The effects can be extensive because IT affects the way transactions are initiated, authorized, recorded, processed, and reported. The effect on internal control is related more to the nature and complexity of the system than to the client's size. Use of the Internet or any other information technology does not necessarily mean that an entity's internal control is heavily dependent on IT. Many small and midsize governmental units and nonprofit organizations have simple computer operations. Typically, they use personal computers, which may be linked in a local area network (LAN), and purchased software packages for specific applications, such as accounts receivable. However, some entities may have internal control that is heavily dependent on IT.

Information that may be useful in understanding the effect of IT on internal control includes understanding the role of IT in initiating, authorizing, recording, processing, and reporting transactions. While information systems may use off-the-shelf software or custom developed applications, the auditor would also consider spreadsheets developed by end users that are used for accounting functions. Understanding how the client manages IT includes understanding the persons and third parties who support the IT infrastructure, along with those parties responsible for managing the deployment and integrity of the infrastructure.

The GAS/SA Audit Guide, Paragraph 9.20, explains that it is especially important in a compliance audit for the auditor to obtain an understanding of how the entity has responded to risks arising from IT because the information systems and programs may include controls related to direct and material compliance requirements. The use of IT might affect any of the five components of internal control relevant to achieving financial reporting, operations, or compliance objectives, as well as the entity's operating units or business functions.

Considering IT Risks. AU-C 315.22 indicates that in understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT. Such controls not only include properly designed and implemented application controls, but the general controls upon which application controls depend. The AICPA Risk Assessment Audit Guide, Paragraph 4.63, notes that the auditor evaluates the design of IT general controls and determines whether they have been implemented to assess the risks of material misstatement. The auditor tests general controls when he or she plans to rely on IT application controls to modify the nature, timing, and extent of substantive tests.

Other Considerations. The auditor also ought to be aware that the use of IT may impact the availability of information needed for the audit. Furthermore, in certain situations the auditor may be precluded from using only substantive procedures when the role of IT is significant to the processing of the transaction. For example, in highly automated processing with little or no manual intervention when information is initiated, authorized, recorded, processed, or reported electronically, the auditor may determine that detection risk cannot be adequately reduced without testing the operating effectiveness of controls.

Considering Whether Specialized IT Skills Are Needed to Understand Internal Control. Auditors need to consider whether specialized IT skills are necessary to determine the effect of IT on the audit, identify and assess IT risks, understand IT controls, design and perform tests of IT controls or substantive procedures, or identify IT control deficiencies. That determination ought to be made relatively early in the planning process to assure that the necessary resources are available on a timely basis. The decision to use an IT specialist is a matter of auditor judgment.

***Government Auditing Standards* Requirements for Use of a Specialist.** Because auditors have to follow *Government Auditing Standards* when performing a single audit, the auditor has additional matters to consider when specialists are used on a single audit. Those matters include—

- *Technical Knowledge.* Paragraph 3.72 of the Yellow Book states that the staff assigned to conduct a Yellow Book audit "should collectively possess the technical knowledge, skills, and experience necessary to be

competent for the type of work being performed before beginning work on that audit." It further indicates that appropriate skills include:

- statistical or nonstatistical sampling (if the work involves use of sampling);
- information technology (if the work involves review of information systems);
- engineering (if the work involves review of complex engineering data);
- specialized audit methodologies or analytical techniques, such as the use of complex survey instruments, actuarial-based estimates, or statistical analysis tests, as applicable; or
- specialized knowledge in subject matters, such as scientific, medical, environmental, educational, or any other specialized subject matter (if the work needs such expertise).

- *Continuing Professional Education.* The Yellow Book, at Paragraph 3.81, establishes a requirement for the audit team to determine that internal specialists who are performing work in accordance with *Government Auditing Standards* as part of the audit team, including directing, performing audit procedures, or reporting on the audit, comply with *Government Auditing Standards*, including the CPE requirements. It further states that, because internal specialists apply specialized knowledge in government audits, training in their areas of specialization qualify under the requirement for 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the entity operates. Internal specialists who are consulting on a Yellow Book audit and are not involved in directing, performing audit procedures, or reporting on it are exempt from Yellow Book CPE requirements. However, Paragraph 3.80 of the Yellow Book establishes a requirement for the audit team to determine that such internal specialists are qualified and competent in their areas of specialization. Paragraph 3.79 of the Yellow Book establishes a similar exemption for external specialists and a similar requirement for the audit team to determine that external specialists are qualified and competent in their areas of specialization.

Documentation

The auditor is required to document the understanding obtained for each of the five components of internal control. The auditor should also document the sources of the information used and risk assessment procedures that were performed to obtain the understanding.

Understanding the Components of Internal Control

The following paragraphs provide an explanation of each of the five components of internal control that the auditor is required to understand in either an audit of the financial statements or an audit of compliance. One of the significant findings stated in the Report on the National Single Audit Sampling Project was a failure by auditors to identify and test all five components of internal control over each applicable compliance requirement.

Control Environment. The control environment sets the tone of an entity and influences the control consciousness of its people. The control environment is the foundation for all other components of internal control over compliance and provides structure and discipline. Among the important elements of the control environment are the attitude, awareness, and actions of management, as well as those charged with governance, concerning internal control. According to AU-C 315.A79, the elements of the control environment that may be relevant when understanding the control environment include the following:

- Communication and enforcement of integrity and ethical values.
- Commitment to competence.
- Participation of those charged with governance.
- Management's philosophy and operating style.

- Organizational structure.
- Assignment of authority and responsibility.
- Human resource policies and procedures.

The auditor generally obtains a sufficient knowledge of the control environment as a result of performing risk assessment procedures to understand the attitudes, awareness, and actions of management and those charged with governance concerning internal control and its importance in achieving reliable reporting and compliance. The auditor should evaluate whether the control environment elements collectively provide support for the other components of internal control and whether those other components are undermined by deficiencies in the control environment. The responsibilities assumed by management and those charged with governance related to financial reporting and compliance are particularly important. For example, the auditor might identify the members of management and governing board members, if any, who are expected to understand the entity's transactions and activities and to evaluate whether they are appropriately reflected in the financial statements and other records, and reflect compliance with applicable compliance requirements, laws, and regulations. The auditor considers both (a) the aspects of the control environment that help ensure compliance and/or the integrity of financial reporting (that is, the key control environment controls) and (b) any control environment weaknesses that could have a pervasive effect on the financial statements or on compliance.

Risk Assessment. An entity's risk assessment process is the process of setting objectives; prioritizing and linking those objectives; and identifying, analyzing, and managing risks relevant to achieving those objectives. Risk assessment for financial reporting purposes can be described as the identification, analysis, and management of the risks of material misstatement of the financial statements. In terms of the compliance portion of a single audit, it can be described as identification, analysis, and management of the risks of material noncompliance.

Risk assessment, as described in AU-C 315.16–.18, is not the same as an auditor's consideration of audit risk (inherent risk, control risk, and detection risk) in a financial statement audit. An auditor assesses inherent and control risks to evaluate the likelihood that the financial statements could be materially misstated. An entity's risk assessment, on the other hand, is the process of identifying, analyzing, and managing risks that affect the entity's objectives. For example, procedures relating to identifying risks of noncompliance and taking steps to manage those risks would be part of risk assessment.

The auditor generally obtains sufficient knowledge of management's risk assessment process to understand how management considers and decides about actions to address risks relevant to the entity's reporting and compliance objectives. This includes gaining an understanding about how management identifies risks relevant to reliable financial reporting or to compliance, estimates the significance of those risks, assesses the likelihood of their occurrence, and decides on actions to manage those risks. For example, if the entity is expanding its activities, the auditor needs to gain an understanding of management's assessment of the impact on internal control and the steps management is taking to address that impact. For risks related to fraud, the auditor needs to gain an understanding of whether the entity has assessed its vulnerabilities to fraudulent activity (including determining whether those exposures could result in material misstatement of the financial statements or schedule of expenditures of federal awards or material noncompliance with provisions of laws, regulations, contracts, or grant agreements) and whether the entity has identified and implemented the processes, controls, and other procedures needed to mitigate identified fraud risk. In some entities, the use of IT may be important in providing timely information to assist management in identifying and managing risks.

AU-C 315.17–.18 requires the auditor to obtain an understanding of the entity's risk assessment process and the results of that process. If the auditor identifies risks of material misstatement or material noncompliance that the entity did not identify, the auditor should evaluate whether the entity's risk assessment process failed and, if so, why it failed and whether the process is appropriate in the circumstances or contains a significant deficiency or material weakness. If the entity does not have a formal risk assessment process, the auditor should discuss with management whether risks relevant to financial reporting have been identified and how they were addressed. The auditor should also evaluate whether the lack of a documented process is appropriate for the entity or represents an internal control deficiency that needs to be evaluated to determine whether it is a significant deficiency or material weakness.

Information and Communication. Information and communication systems support the identification, capture, and exchange of information in a form and timeframe that enable individuals to carry out their responsibilities. The information system relevant to financial reporting and compliance consists of procedures and records established to initiate, authorize, record, process, report transactions and compliance, and to maintain accountability for the organization's assets, liabilities, and equity. An information system may be automated, manual, or a combination of the two, depending on the size and complexity or the entity. Communication is the process of providing an understanding of roles and responsibilities to individuals within the organization regarding internal control over financial reporting and compliance.

Information System. *Information system* refers to the financial reporting system, which includes the accounting system. The auditor's consideration of the information system focuses on making an overall evaluation of the use and flow of information relevant to reliable financial reporting and to compliance rather than on obtaining an understanding of specific processes. For example, the auditor considers whether the client has controls in place to effectively support it in identifying, capturing, and using all of the information needed to prepare reliable financial statements and to maintain compliance with the provisions of laws, regulations, contracts, and grant agreements.

Communication. Communication relates to providing a clear understanding of internal control over financial reporting and over compliance, how they work, and the roles and responsibilities of individuals within the entity related to internal control. The communication process includes both internal and external elements. For example, it includes communications between management and employees, those charged with governance, and regulatory authorities. Communication may take the form of policy manuals, memorandums, oral or electronic communications, etc. This will depend on the size and organizational structure of the entity. Auditors consider both:

- The aspects of the communication process that help to ensure employees and those charged with governance understand their jobs and responsibilities within the financial reporting system and are encouraged to report any exceptions.
- Any areas where communication does not occur.

Monitoring. Monitoring is a process by which an entity assesses the effectiveness of its internal control over compliance performance over time. Monitoring involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. Monitoring activities can also reveal evidence or symptoms of fraud. Effective monitoring ensures that internal controls are modified as changes in conditions occur in the business. As a result, poor monitoring controls can allow error or fraud to remain undetected. The elements of an entity's monitoring process include (a) ongoing and/or separate evaluations and (b) evaluation and reporting of internal control deficiencies. Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring includes management and supervisory activities and other actions that personnel take in performing their duties, such as performing comparisons, reconciliations, and other routine activities.

According to AU-C 315.23, the auditor should obtain an understanding of the major types of activities that management uses to monitor internal control over financial reporting, including control activities relevant to the audit. AU-C 315.25 further indicates that the auditor's understanding should include the sources of information related to monitoring and the basis on which management considers information to be sufficiently reliable for that purpose. The auditor considers both (a) the aspects of the monitoring process that enable management to appropriately identify and correct control procedures that are not operating as intended and (b) any circumstances that indicate management has failed to appropriately identify and correct such deficiencies. Monitoring can be virtually any activity that ensures that controls are operating as intended and continue to be properly designed. Monitoring activities have more significance when an entity passes through federal awards to subrecipients.

Control Activities. Control activities are the policies and procedures that help ensure that management directives are carried out. They can be either automated or manual and are performed at various levels within the entity. AU-C 315.21 requires the auditor to obtain an understanding of control activities relevant to the audit and explains that they are ones that the auditor considers it necessary to understand in order to assess the risks of material misstatement at the assertion level or material noncompliance and design further audit procedures responsive to assessed risks. This means that the auditor focuses on identifying and obtaining an understanding of control activities that address areas in which the auditor considers material misstatements or noncompliance more likely to

occur. The auditor concentrates on whether and how a specific control activity, individually or in combination with others, prevents, or detects and corrects, material misstatements in the classes of transactions, account balances, or disclosures that are significant to the financial statements, schedule of expenditures of federal awards, or program financial reports, whether and how it prevents, or detects and corrects material noncompliance. Specifically, the auditor needs to understand the entity's controls related to fraud risks and other significant risks and also the risks for which substantive procedures alone will not be adequate. Also, as required by AU-C 315.22, the auditor should understand how IT affects control activities that are relevant to planning the audit. IT systems and programs may include controls related to direct and material compliance requirements or may be critical to the effective functioning of manual controls that depend on IT. Control activities, whether automated or manual, cover a range of activities, including performance reviews, information processing controls, physical controls, segregation of duties, and asset accountability.

Also critical to control activities are the follow-up actions taken in response to identified discrepancies (for example, investigation by management of unexpected variances noted while comparing actual expenditures to budgeted expenditures). Auditing standards specifically require the auditor to obtain an understanding of how the incorrect processing of transactions is resolved.

As part of obtaining an understanding of the control environment, risk assessment, information and communication, and monitoring components of internal control, the auditor inevitably learns something about control activities. An audit does not require an understanding of all control activities. The auditor first considers the knowledge about control activities obtained from the understanding of the other components of internal control before devoting additional attention to obtaining an understanding of control activities. Auditing standards specifically require the auditor to obtain an understanding of the process of reconciling detail to the general ledger for significant accounts. While reconciling procedures are technically a control activity, the auditor's understanding is typically obtained when developing a knowledge of the flow of transactions. Additional responsibilities when performing a single audit are discussed later in this lesson.

In determining the knowledge of control activities necessary to identify types of potential misstatements or noncompliance and develop appropriate responses, the auditor considers experience with the client in prior audits and the knowledge and understanding of the entity and its industry, including the discussion among the engagement team about the risks of fraud and the information gathered to identify fraud risks. The auditor also considers the complexity and sophistication of the client's operations and financial reporting system.

In certain circumstances, the auditor's understanding of control activities may need to be more extensive than the knowledge gained when obtaining an understanding of the other four components of internal control. If the complexity or sophistication of the entity's operations limit the auditor's knowledge of potential material misstatements or noncompliance, a further understanding of control activities is necessary. For example, a further understanding of control activities may be necessary when the client depends heavily on the computer to initiate transactions or accounting entries, or to process and control substantially all of the information with little or no user involvement, in one or more significant applications. In such a situation, a further understanding of general, application, and user computer controls is generally necessary. If the auditor has an adequate knowledge of the potential causes of material misstatements or noncompliance, it may be possible to design effective audit tests without a further understanding of control activities. The key is always what is necessary to design effective audit tests in the circumstances.

SELF-STUDY QUIZ

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

16. What piece of authoritative guidance requires nonfederal entities to establish and maintain internal control over federal awards that effectively provides reasonable assurance that the entity manages the awards in compliance with federal statutes, regulations, and any specific terms and conditions?

    a. AU-C 935, *Compliance Audits*.

    b. COSO's *Internal Control—Integrated Framework*.

    c. The Single Audit Act Amendments of 1996.

    d. The Uniform Guidance.

17. What is one reason why auditors perform risk assessment procedures when gaining an understanding of internal control in a typical audit?

    a. To evaluate the design of all the entity's controls.

    b. To determine if the necessary controls have been implemented.

    c. To assess the risk of material misstatement of the financial statements due to error or fraud.

    d. To obtain audit evidence about controls over federal awards.

18. Which of the following statements best describes an aspect of how information technology (IT) affects internal control?

    a. IT is most relevant to the monitoring element of internal control.

    b. The complexity of the IT system determines its effect on internal control.

    c. If a client uses the Internet, its internal control is considered heavily dependent on IT.

19. Which element of internal control is defined as the policies and procedures that help management ensure its directives are carried out?

    a. Control environment.

    b. Risk assessment.

    c. Monitoring.

    d. Control activities.

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.)**

16. What piece of authoritative guidance requires nonfederal entities to establish and maintain internal control over federal awards that effectively provides reasonable assurance that the entity manages the awards in compliance with federal statutes, regulations, and any specific terms and conditions? **(Page 224)**

    a. AU-C 935, *Compliance Audits*. [This answer is incorrect. Auditors should have a thorough working knowledge of certain pronouncements, including AU-C 935, to perform this type of audit; however, AU-C 935 is not the authoritative guidance that makes the requirement described above.]

    b. COSO's *Internal Control—Integrated Framework*. [This answer is incorrect. The authoritative guidance described above specifies that the internal control over federal awards should be in compliance with guidance in *Standards for Internal Control in the Federal Government* (the Green Book) or with *COSO's Internal Control—Integrated Framework* (COSO Framework). Therefore, the piece of authoritative guidance described above is more overarching than either the Green Book or the COSO Framework.]

    c. The Single Audit Act Amendments of 1996. [This answer is incorrect. Congress, the Governmental Accountability Office (GAO), and the Office of Management and Budget (OMB) have issued regulations and publications that are relevant to the requirements for testing and reporting on internal control, such as the Single Audit Act Amendments. However, though the topic is related, the Single Audit Act Amendments do not outline the specific requirements listed above.]

    d. The Uniform Guidance. [This answer is correct. OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) requires nonfederal entities to establish and maintain effective internal control over federal awards that provides reasonable assurance that the awards are being managed in compliance with federal statutes, regulations, and the terms and conditions of the federal award.]

17. What is one reason why auditors perform risk assessment procedures when gaining an understanding of internal control in a typical audit? **(Page 225)**

    a. To evaluate the design of all the entity's controls. [This answer is incorrect. One reason that auditors perform risk assessment procedures for this purpose is to evaluate the design of controls that are relevant to the audit. Therefore, making this determination about all of an entity's controls would be overauditing.]

    b. To determine if the necessary controls have been implemented. [This answer is correct. One reason that auditors perform risk assessment procedures is to determine if controls relevant to the audit have been implemented.]

    c. To assess the risk of material misstatement of the financial statements due to error or fraud. [This answer is incorrect. AU-C 315.13–.14 requires auditors to obtain an understanding of internal control that is sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures. Therefore, this is part of the reason for obtaining an overarching understanding of internal control. Performing risk assessment procedures is part of obtaining that understanding and has its own associated reasons for the action.]

    d. To obtain audit evidence about controls over federal awards. [This answer is incorrect. In a Uniform Guidance audit of compliance, the auditor performs risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls over federal awards; however, this is a different type of audit engagement than the one described above.]

18. Which of the following statements best describes an aspect of how information technology (IT) affects internal control? **(Page 229)**

    a. IT is most relevant to the monitoring element of internal control. [This answer is incorrect. AU-C 315 indicates that auditors should consider how IT affects an entity's control activities, which is a different element of internal control from monitoring.]

    b. The complexity of the IT system determines its effect on internal control. [This answer is correct. The effects of IT can be extensive because IT affects the way transactions are initiated, authorized, recorded, processed, and reported. The effect on internal control is related more to the nature and complexity of the system than to the client's size.]

    c. If a client uses the Internet, its internal control is considered heavily dependent on IT. [This answer is incorrect. Use of the Internet or any other information technology does not necessarily mean that an entity's internal control is heavily dependent on IT. Many small and midsize governmental units and nonprofit organizations have simple computer operations.]

19. Which element of internal control is defined as the policies and procedures that help management ensure its directives are carried out? **(Page 232)**

    a. Control environment. [This answer is incorrect. The control environment sets the tone of an entity and influences the control consciousness of its people. This is more of an overarching concept than the specific policies and procedures described above.]

    b. Risk assessment. [This answer is incorrect. An entity's risk assessment process is the process of setting objectives; prioritizing and linking those objectives; and identifying, analyzing, and managing risks relevant to achieving those objectives. Therefore, the element of internal control described above will support the risk assessment element of internal control.]

    c. Monitoring. [This answer is incorrect. Monitoring is a process by which an entity assesses the effectiveness of its internal control over compliance performance over time. Therefore, monitoring has a different focus than the element of internal control described above.]

    d. Control activities. [This answer is correct. Control activities are the policies and procedures that help ensure that management directives are carried out. They can be either automated or manual and are performed at various levels within the entity.]

RESPONSIBILITIES FOR INTERNAL CONTROL IN ALL AUDITS

The auditor's responsibility for considering internal control in any audit made in accordance with GAAS, including a single audit, were discussed in the previous section. AU-C 315.13–.14 requires auditors to obtain an understanding of the five components of internal control that is sufficient to assess the risk of material misstatement of the financial statements due to error or fraud. In financial statement audits, including those conducted under *Government Auditing Standards*, the auditor's understanding of internal control needs to incorporate knowledge about controls relevant to compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts.

AU-C 315.14 states that the understanding of internal control should include an evaluation of the design of controls that are relevant to the audit and a determination of whether they have been implemented. To verify whether a control has been implemented, the auditor generally uses procedures such as observation or inspection, in concert with responses to inquiries. As previously discussed, inquiry alone cannot provide a sufficient understanding of internal control.

The evaluation of control design and implementation serves a different purpose than tests of controls. The evaluation of control design and implementation, which is accomplished through the performance of risk assessment procedures, is necessary to assess the risk of material misstatement of the financial statements. Based on that assessment, the auditor determines which further audit procedures to perform. Further audit procedures may include tests of the operating effectiveness of controls. Unlike the evaluation of control design and implementation, which is required in every audit, tests of controls, which are categorized as further audit procedures, are not required in every audit.

In addition, as indicated in AU-C 330.A22, testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls, even though the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time the auditor is evaluating their design and determining that they have been implemented. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied.

AU-C 315.A76 describes the procedures auditors may use to obtain audit evidence about the design and implementation of relevant controls as follows:

- Inquiry of entity personnel.
- Observation of the application of specific controls.
- Inspection of documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

The extent of procedures performed to obtain an understanding of internal control will depend largely on the complexity of the entity's operations and accounting systems. Additionally, whether the organization has decentralized accounting systems will also impact the extent of work necessary since an understanding is needed for all of the systems being used. The auditor needs to perform procedures sufficient to learn about the components of internal control and how the financial reporting system functions.

The auditor's understanding of internal control should include the entity's programs and controls that address risks of material misstatement that are considered significant risks. Fraud risks are always considered to be significant risks. In addition, significant risks often relate to nonroutine transactions, for example, with related parties and judgmental matters, such as estimates. Also, revenue recognition issues often pose significant risks. According to AU-C 240.27, after completing the risk assessment procedures to evaluate internal control design and implementation, the auditor determines whether a sufficient understanding has been obtained of controls that would prevent, or detect and correct, material misstatements related to fraud risks or other significant risks. If not, the auditor performs additional risk assessment procedures directed at gaining an understanding of controls relating to those risks.

The nonauthoritative AICPA Technical Question and Answer, *Defaulting to Maximum Control Risk* (Q&A 8200.10), reminds auditors that the ability to default control risk to the maximum level is not allowed under AU-C 315. In a financial statement audit, testing of controls is not required unless the auditor intends to rely on the operating effectiveness of controls to alter the nature, timing, and extent of further audit procedures, or the auditor concludes that substantive procedures alone will not sufficiently reduce detection risk. However, as explained in the next section, audits performed under the Uniform Guidance require additional consideration of internal control. The control environment, risk assessment, information and communication, control activities, and monitoring components of internal control which assure compliance will in most instances require further understanding and tests of controls. Accordingly, even if control risk is assessed at the maximum for the financial statement audit, it will not decrease the testing of controls required in a Uniform Guidance audit of compliance.

ADDITIONAL INTERNAL CONTROL RESPONSIBILITIES FOR SINGLE AUDITS

The Uniform Guidance, at 2 CFR section 200.62, defines internal control pertaining to the compliance requirements for federal programs as a process implemented by a nonfederal entity designed to provide reasonable assurance regarding the achievement of the following objectives for federal awards:

- Transactions are properly recorded and accounted for in order to:
  - Permit the preparation of reliable financial statements and federal reports.
  - Maintain accountability over assets.
  - Demonstrate compliance with federal statutes, regulations, and the terms and conditions of federal awards.
- Transactions are executed in compliance with:
  - Federal statutes, regulations, and the terms and conditions of federal awards that could have a direct and material effect on a federal program.
  - Any other federal statutes and regulations that are identified in the Compliance Supplement.
- Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

In addition to the GAAS and *Government Auditing Standards* requirements discussed previously, the Uniform Guidance states that the auditor must do the following:

- Perform procedures to obtain an understanding of internal control over federal programs sufficient to plan the audit to support a low assessed level of control risk of noncompliance for major programs.
- Plan tests of internal control over compliance for major programs to support a low assessed level of control risk of noncompliance for the assertions relevant to the compliance requirements for each major program.
- Perform tests of internal control over compliance as planned.
- Report on internal control over compliance describing the scope of the testing of internal control and the results of the tests and, when applicable, referring to the separate schedule of findings and questioned costs.

AU-C 935.15 states that for each major program and each compliance requirement selected for testing, the auditor should perform risk assessment procedures to obtain a sufficient understanding of the compliance requirement and internal control over compliance with the compliance requirement. AU-C 935.16 states:

> In performing risk assessment procedures, the auditor should inquire of management about whether there are findings and recommendations in reports or other written communications

> resulting from previous audits, attestation engagements, and internal or external monitoring that directly relate to the objectives of the compliance audit. The auditor should gain an understanding of management's response to findings and recommendations that could have a material effect on the entity's compliance with the applicable compliance requirements (for example, taking corrective action). The auditor should use this information to assess risk and determine the nature, timing, and extent of the audit procedures for the compliance audit, including determining the extent to which testing the implementation of any corrective actions is applicable to the audit objectives.

AU-C 935.205 states that the auditor should design and perform further audit procedures that include tests of the operating effectiveness of controls over each applicable compliance requirement if (a) the auditor's risk assessment includes an expectation of the operating effectiveness of controls over compliance for the applicable compliance requirements, (b) substantive procedures alone do not provide sufficient appropriate audit evidence, or (c) tests of controls over compliance are required by the governmental audit requirement. As discussed later in this lesson, tests of controls are required by 2 CFR section 200.514(c)(3).

The consideration of internal control over compliance for each major program is similar to the consideration of internal control over financial reporting. The same concepts apply regarding assessing risk, understanding internal control over compliance, and testing controls. However, the consideration of internal control in a Uniform Guidance audit of compliance is also directed toward compliance with federal statutes, regulations, and the terms and conditions of the federal awards. In the consideration of internal control over compliance, the auditor—

- Obtains a sufficient understanding of the five components of internal control to assess the risks of material noncompliance with each direct and material compliance requirement of each major program. To obtain this understanding, the auditor performs risk assessment procedures to evaluate the design of controls relevant to the compliance audit and to determine whether they have been implemented.

- Uses the information gathered from risk assessment procedures to make a preliminary risk assessment. This preliminary risk assessment should be used to determine the nature, timing, and extent of further audit procedures to be performed.

Obtaining an Understanding of Internal Control

When auditing under the Uniform Guidance, the auditor needs to not only be concerned with obtaining an understanding of internal control over financial reporting, but also the internal controls over federal awards. 2 CFR section 200.303 requires nonfederal entities to establish and maintain effective internal control over federal awards that provides reasonable assurance that the awards are being managed in compliance with federal statutes, regulations, and the terms and conditions of the federal award. The internal controls should be in compliance with guidance in *Standards for Internal Control in the Federal Government* (the "Green Book") or with COSO's Internal Control-Integrated Framework (COSO Framework). The GAS/SA Audit Guide, Paragraph 9.65, clarifies that there is no expectation or actual requirement for (a) an entity to document or evaluate internal controls prescriptively in accordance with the Green Book or the COSO Framework or (b) the entity or its auditor to reconcile technical differences between them. Nonfederal entities and their auditors will need to exercise judgment in determining the most appropriate and cost effective internal control in a given environment or circumstance.

Paragraph 9.13 of the GAS/SA Audit Guide explains that "the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material noncompliance with *each* direct and material compliance requirement for *each* major program." [Emphasis added.] To obtain a sufficient understanding, the auditor should:

- Perform risk assessment procedures to evaluate the design of controls relevant to the compliance audit and to determine whether they have been implemented.

- Use the information gathered by performing the risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment.

- Use the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.

Paragraph 9.14 of the GAS/SA Audit Guide explains that controls used by entities may be the same for multiple federal programs and similar transactions (such as cash disbursements). Those controls will often provide assurance regarding the achievement of the compliance objectives related to transactions and assets of some or all federal programs. However, the use of the same controls does not eliminate the need for the auditor to obtain an understanding of internal control over compliance for each major program.

Paragraph 9.15 of the GAS/SA Audit Guide explains that AU-C 935.20 requires the auditor to design and perform further audit procedures in response to the assessed risks of material noncompliance. The auditor's procedures should include performing tests of controls over compliance in any of the following circumstances:

- The risk assessment includes an expectation that controls over compliance related to the direct and material compliance requirements are operating effectively.

- Substantive procedures alone do not provide sufficient appropriate audit evidence.

- Tests of controls over compliance are required by the governmental audit requirement (which would be the case in a single audit).

According to Paragraph 9.16 of the GAS/SA Audit Guide, the auditor might perform procedures for gaining an understanding of internal control over compliance concurrently with assessing the risks of noncompliance. Similarly, depending on the assessed level of control risk of noncompliance that the auditor expects to support and on audit efficiency considerations, the auditor might perform some tests of controls concurrently with obtaining an understanding of controls.

Paragraph 9.19 of the GAS/SA Audit Guide states:

> For each of the programs and direct and material compliance requirements selected for testing, the auditor should perform risk assessment procedures to obtain a sufficient understanding of the direct and material compliance requirements and the entity's internal control over compliance with those compliance requirements. The objective of these procedures is to obtain audit evidence about the design and implementation of relevant controls over compliance, and may include procedures such as inquiry of entity personnel, observing the application of a specific control, and inspecting documents and reports.

Controls at Multiple Organizational Units. Frequently, a recipient's federal award programs are administered by multiple organizational units (e.g., operating units, branches, or locations), each of which might maintain separate internal control over compliance. Paragraph 9.24 of the GAS/SA Audit Guide indicates that, in this situation, the auditor should perform procedures to obtain an understanding of internal control over compliance that is separately maintained and is relevant to each material part of a major program, and should plan and perform tests of those controls.

Compliance Supplement Guidance. In order to obtain a sufficient understanding of the five components of internal control, the auditor needs to first identify, for each major program, which of the 12 types of compliance requirements have a direct and material effect on the program. Part 6 of the *OMB Compliance Supplement* addresses the objectives, principles, and components of internal control based on the Green Book and COSO Framework. It provides an overview of internal control, discusses the Green Book and COSO Framework, and describes characteristics of internal control relating to each of the five components of internal control (as defined by the Green Book). Part 6 also discusses how those characteristics relate to the 17 principles of internal control. Part 6 is not a checklist of required internal control characteristics; however, it may help when planning and performing a Uniform Guidance compliance audit.

A system of internal control needs to provide reasonable assurance that control objectives of internal control over compliance requirements relating to compliance with federal statutes, regulations, and the terms and conditions of Federal awards will be achieved. Part 6 of the 2017 Compliance Supplement states that the objectives of internal control over compliance requirements for federal awards (2 CFR 200.62) are as follows:

- Transactions are properly recorded and accounted for in order to (a) permit the preparation of reliable financial statements and federal reports, (b) maintain accountability over assets, and (c) demonstrate compliance with federal statutes, regulations, and the terms and conditions of the federal award.

- Transactions are executed in compliance with (a) federal statutes, regulations, and the terms and conditions of the federal award that could have a direct and material effect on a federal program and (b) any other federal statutes and regulations identified in the Compliance Supplement.

- Funds, property, and other assets are safeguarded against loss from unauthorized use of disposition.

Part 6 of the Compliance Supplement states that internal control should (a) be an integral part of an entity's entire cycle of planning, budgeting, management, accounting, monitoring, and reporting, and (b) support the effectiveness and the integrity of every step of the process and provide continual feedback to management. It further explains:

> Non-Federal entities' program managers must carefully consider the appropriate balance between controls and risk in their programs and operations. Too many controls can result in inefficient and ineffective operations; managers must ensure an appropriate balance between the strength of controls and the relative risk associated with particular grant award programs and operations. Additionally, the benefits of controls should outweigh the costs. Non-Federal entities should consider both qualitative and quantitative factors when analyzing costs against benefits.

The Green Book and COSO Framework set forth five interrelated components of internal control: control environment, risk assessment, control activities, information and communication, and monitoring. The COSO Framework sets forth 17 principles related to the components. The Green Book adapted the principles for a government environment. Part 6 of the Compliance Supplement notes that because COSO and the Green Book have the same components of internal control and similar principles, for simplicity, the discussion in much of Part 6 is based on the Green Book. Part 6 of the Compliance Supplement describes characteristics relating to each of the five components of internal control (as defined by the Green Book) that "should reasonably ensure compliance with the requirements of Federal statutes, regulations, and the terms and conditions of Federal awards," and relates those characteristics to the principles. Exhibit 2-1 illustrates those components, principles, and characteristics.

Exhibit 2-1

Internal Control Components, Principles, and Characteristics
Based on Part 6 of the 2017 Compliance Supplement

Component	Principle	Characteristics
Control Environment—The foundation for an internal control system. It provides the discipline and structure to help an entity achieve its objectives.	1. Demonstrate commitment to integrity and ethical values	• There is a sense of conducting operations ethically, as evidenced by a code of conduct or other verbal or written directive.
		• Management makes evident its support of adequate information and reporting systems.
	2. Exercise oversight responsibility	• There is a governing Board or equivalent that is responsible for engaging the auditor, receiving all reports and communications from the auditor, and ensuring that audit findings and recommendations are adequately addressed, and it fulfills those responsibilities.
	3. Establish structure, responsibility, and authority	• Key managers' responsibilities are clearly defined.
		• The Board has established an audit committee.
	4. Demonstrate commitment to competence	• Key managers have adequate knowledge or experiences to discharge their responsibilities.
		• Management's commitment to competence ensures that staff members receive adequate training to perform their duties.
		• Staff members are knowledgeable about compliance requirements and are given responsibility to communicate all instances of noncompliance to management.
		• Management initiates positive responsiveness to prior compliance and control findings.
	5. Enforce accountability	• Management demonstrates respect for and adherence to program compliance requirements.
Risk Assessment—Assesses the risks facing the entity as it seeks to achieve its objectives. This assessment provides the basis for developing appropriate risk responses.	6. Define objectives and risk tolerances	• Program managers and staff understand and have identified key compliance objectives and risk tolerances.

Component	Principle	Characteristics
	7. Identify, analyze, and respond to risks	• Management is aware of results of monitoring, audits, and reviews, and considers related risk of noncompliance.
		• Management and employees identify, analyze, and adequately respond to risks related to achieving the defined objectives.
		• The organizational structure provides identification of risks of noncompliance.
		•• Key managers have been given responsibility to identify and communicate changes.
		•• Employees who require close supervision (e.g., they are inexperienced) are identified.
		•• Management has identified and assessed complex operations, programs, or projects.
	8. Assess fraud risk	• Management considers the potential for fraud when identifying, analyzing, and responding to risk. The assessment includes, at a minimum, types of fraud, fraud risk factors, and response to fraud risks.
	9. Identify, analyze, and respond to change	• Processes are established to implement significant changes in program objectives and procedures.
Control Activities—The actions management establishes through policies and procedures to achieve objectives and respond to risks in the internal control system, which includes the entity's information system.	10. Design control activities	• Adequate segregation of duties is provided between performance, review, and recordkeeping of a task.
		• Supervision of employees is commensurate with their level of competence.
		• Personnel possess adequate knowledge and experience to discharge their responsibilities.

Component	Principle	Characteristics
		• Equipment, inventories, cash, and other assets are secured physically and periodically counted and compared to recorded amounts.
	11. Design activities for the information system	• Computer and program controls include (a) data entry controls such as edit checks, (b) exception reporting, (c) access controls, (d) reviews of input and output data, and (e) computer general controls and security controls.
		• Operating policies and procedures exist and are clearly written and communicated.
		• Procedures are in place to implement changes in statutes, regulations, and the terms and conditions affecting federal awards.
		• Management prohibits intervention or overriding established controls.
		• If there is a governing Board, the Board conducts regular meetings where financial information is reviewed and the results of program activities and accomplishments are discussed. Written documentation is maintained of the matters addressed at such meetings.
	12. Implement control activities	[no characteristics provided]
Information and Communication—The quality of information management and personnel communicate and use to support the internal control system.	13. Use quality information	• The accounting system provides for separate identification of federal and nonfederal transactions and allocation of transactions applicable to both.
		• Adequate source documentation exists to support amounts and items reported. A recordkeeping system is established to ensure that accounting records and documentation are retained for the time period required in the statutes, regulations, and the terms and conditions applicable to the program.
		• Accurate information is accessible to those who need it.
		• Reports are provided timely to managers for review and appropriate action.

Component	Principle	Characteristics
		• Reconciliations and reviews ensure accuracy of reports.
		• Actions are taken as a result of communications received.
	14. Communicate internally	• Established internal and external communication channels exist (staff meetings; bulletin boards; memos, circulation files, email; surveys, suggestion box).
		• Employees' duties and control responsibilities are effectively communicated.
		• Channels of communication for people to report suspected improprieties have been established.
	15. Communicate externally	• There are established channels of communication between the pass-through entity and subrecipients.
Monitoring—Activities management establishes and operates to assess the quality of performance over time and promptly resolve the findings of audits and other reviews.	16. Perform monitoring activities	• Ongoing monitoring is built-in through independent reconciliations, staff meeting feedback, rotating staff, supervisory review, and management review of reports.
		• Periodic site visits are performed at decentralized locations (including subrecipients' locations) and checks are performed to determine whether procedures are being followed as intended.
		• Management meets with program monitors, auditors, and reviewers to evaluate the condition of the program and controls.
	17. Evaluate issues and remediate deficiencies	• Management follows up on irregularities and deficiencies to determine the cause.
		• Internal quality control reviews are performed.

Component	Principle	Characteristics
		• Internal audit routinely tests for compliance with federal requirements.
		• If there is a governing Board, the Board reviews the results of all monitoring or audit reports and periodically assesses the adequacy of corrective action.

* * *

Part 3 of the Compliance Supplement provides suggested audit procedures for internal control for each of the types of compliance requirements except Special Tests and Provisions. For example, Parts 3.1 and 3.2, Section M provide suggested procedures for auditing internal control over subrecipient monitoring. They require the auditor to "plan the testing of internal control to support a low assessed level of control risk for subrecipient monitoring and perform the testing of internal control as planned."

The GAS/SA Audit Guide, Paragraph 9.66, explains that nonfederal entities may have changed or updated their internal controls over compliance to a greater extent than normal as part of their process of implementing the Uniform Guidance. The auditor should consider those changes when obtaining an understanding of internal control over compliance, assessing risk, and testing controls. In addition, the results of prior years' internal control tests might not be relevant to tests of internal control when planning the current year's audit. Furthermore, separate samples may be necessary if internal control has changed significantly or if controls over transactions that are subject to the Uniform Guidance administrative requirements and cost principles are different than controls over transactions that are subject to the previous administrative requirements and cost principles.

The auditor's responsibilities include evaluating internal control over federal awards and planning the audit to support a low assessed level of control risk of noncompliance for each major program. It may be necessary to perform tests of internal control over compliance for control objectives and activities beyond those in the Compliance Supplement. Appropriate documentation is needed.

Evaluating the Design and Implementation of Controls

To identify controls relevant to the direct and material compliance requirements, the auditor should obtain an understanding of each of the five components of internal control relevant to the direct and material compliance requirements for each major program. In obtaining this understanding, the auditor should perform risk assessment procedures to evaluate the design of the controls and determine if the controls have been implemented. In evaluating the design of a control, the auditor considers whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, instances of noncompliance. The auditor considers the design of the control when deciding whether to consider its implementation (i.e., whether the control exists and the entity is using it).

The GAS/SA Audit Guide, at Paragraph 9.19, states that procedures used to evaluate the effectiveness of the design of a control over compliance and its implementation might include (a) inquiries of entity personnel, (b) inspection of documents and reports, and (c) observation of the application of the specific controls. Performing only inquiry is not sufficient for evaluating the design of a control and determining whether it has been implemented.

Assessing Control Risk of Noncompliance

After obtaining an understanding of internal control over compliance for each major program, the auditor makes a preliminary assessment of control risk of noncompliance related to the direct and material compliance requirements for the program and uses the assessment to determine whether a low assessed level of control risk of

noncompliance can be supported. *Control risk of noncompliance* is one of the components of *risk of material noncompliance*. AU-C 935.11 defines *control risk of noncompliance* as:

> The risk that noncompliance with a compliance requirement that could occur and that could be material, either individually or when aggregated with other instances of noncompliance, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control over compliance.

If the auditor concludes that controls are capable of effectively preventing, or detecting and correcting material noncompliance, control risk of noncompliance might initially be assessed at less than the maximum during the risk assessment phase of the audit.

According to AU-C 935.15, the auditor should perform risk assessment procedures to obtain an understanding of applicable compliance requirements and the related internal controls for each program and compliance requirement selected for testing. AU-C 935.16 states that "the auditor should use this information to assess risk and determine the nature, timing, and extent of the audit procedures for the compliance audit, including determining the extent to which testing the implementation of any corrective actions is applicable to the audit objectives."

If the auditor determines that internal control over compliance is effectively designed and implemented, the Uniform Guidance requires the auditor to plan the audit to support a low level of assessed control risk of noncompliance. Thus, the auditor has to plan to obtain a high level of assurance that controls operate as designed. As the assessed level of control risk of noncompliance decreases and the level of assurance increases, the quantity of audit evidence needed to support those levels increases. The type of audit evidence, its source, its timeliness, and the existence of other audit evidence supporting related conclusions all affect the degree of assurance the audit evidence provides.

The level of testing necessary to support a low assessed level of control risk of noncompliance is a matter of auditor judgment. Paragraph 9.28 of the GAS/SA Audit Guide states the following concerning low assessed level of control risk of noncompliance:

> Professional standards do not define or quantify a low assessed level of control risk of noncompliance. Therefore, professional judgment is needed in determining the extent of control testing necessary to obtain a low level of control risk of noncompliance. In exercising professional judgment, one factor to consider is that this requirement is intended to address federal agencies' desire to know if conditions indicate that auditees have not implemented adequate internal control over compliance for federal programs to ensure compliance with federal statutes, regulations, and the terms and conditions of federal awards.

Performing Tests of Controls. As discussed earlier in this lesson, when identifying controls, evaluating design effectiveness, determining implementation, and testing controls, it is often most efficient and effective for the auditor to focus on *key controls*. The auditor should identify the key controls from the population of controls that the auditor determined were placed in operation. It may not be necessary to identify key controls for each of the five components of internal control. The auditor should test the key controls to assess their operating effectiveness. Although all controls considered to be key controls should be tested, the auditor may also decide to test other controls that are not key controls.

As discussed earlier in this lesson, obtaining an understanding of internal control ordinarily does not provide sufficient evidence of the operating effectiveness of controls. Similarly, performing tests of compliance does not provide evidence that controls are appropriately designed or operating effectively. Tests of compliance provide indirect evidence regarding the effectiveness of controls, but cannot be the basis for assessing operating effectiveness. Generally, tests of controls assist the auditor in determining the nature, timing, and extent of substantive audit procedures to be performed to obtain evidence that supports the opinion on compliance.

2 CFR section 200.514(c)(3) requires the auditor to perform testing of internal control over compliance as planned for an exception when there is ineffective internal control). Paragraph 9.36 of the GAS/SA Audit Guide states:

> Testing of the operating effectiveness of controls ordinarily includes procedures such as (a) inquiries of appropriate entity personnel, including grant and contract managers; (b) the inspection of documents,

reports, or electronic files indicating performance of the control; (c) the observation of the application of the specific controls; and (d) reperformance of the application of the control by the auditor. The auditor should perform such procedures regardless of whether he or she would otherwise choose to obtain evidence to support an assessment of control risk of noncompliance below the maximum level.

Part 3 of the 2017 Compliance Supplement includes suggested audit procedures for testing internal control. However, Part 1 of the Compliance Supplement clarifies that "the auditor must determine the specific procedures to test internal control on a case-by-case basis, considering factors such as the non-Federal entity's internal control, the compliance requirements, the audit objectives for compliance, the auditor's assessment of control risk, and the audit requirement to test internal control as prescribed in 2 CFR part 200, subpart F."

Planned versus Achieved Risk Level. The Uniform Guidance only requires that a low assessed level of control risk of noncompliance be *planned for* and that *testing of controls be performed* based on that plan. It does not require, however, that a low assessed level of control risk of noncompliance be achieved. In other words, if deviations in the tests of controls are found, additional selections would not have to be tested. The auditor would only need to report the results of the testing and perform compliance testing based on assessing the control risk of noncompliance at the level actually achieved (either high or moderate), depending on the sample size and number of deviations found. If, however, the control testing supports assessing the control risk at less than high (either low or moderate), the auditor may consider reducing the substantive testing accordingly. Performing tests of the operating effectiveness of controls is discussed later in this lesson.

Ineffective Internal Control. In the event the internal control over some or all of the compliance requirements for a major program is likely to be ineffective in preventing or detecting noncompliance, 2 CFR section 200.514(c)(3) does not require the auditor to plan and perform the tests of internal control over the affected programs. It does, however, require that the auditor report the control deficiency as a significant deficiency or material weakness in internal control over compliance in the schedule of findings and questioned costs, assess control risk at the maximum, and consider whether additional compliance tests are required due to ineffective internal control. Ineffective internal control is discussed further later in this lesson.

Evaluating the Results of Tests of Controls

As discussed above, although the Uniform Guidance requires auditors to obtain an understanding of, plan, and test internal control to support a low assessed level of control risk of noncompliance for major programs, a low assessed level of control risk of noncompliance may not be achieved. Paragraph 9.40 of the GAS/SA Audit Guide indicates that in situations where auditors cannot support a low assessed level of control risk of noncompliance for a direct and material compliance requirement for a major program, they are not required to expand their testing of internal control over compliance for that compliance requirement. Instead, they may choose not to perform additional tests of controls. If auditors decide to expand their testing of internal control over compliance, their decision would be based on whether they consider the additional internal control testing to be more efficient than performing additional tests of compliance.

Program Cluster Considerations. Auditors may need to consider additional issues when entities have separate controls relating to individual federal programs that are treated as a program cluster under the Uniform Guidance. Paragraph 9.59 of the GAS/SA Audit Guide indicates that when evaluating whether an identified deficiency is a significant deficiency or a material weakness in internal control over compliance, the significance of the deficiency in relation to the type of compliance requirement for the cluster of programs is an important factor. One of the examples provided in Paragraph 9.59 indicates that deficiencies in specific controls over time cards of college work-study students would likely be considered a significant deficiency or a material weakness in internal control over compliance if work-study program expenditures are significant in relation to the Student Financial Assistance cluster. However, deficiencies in a single program that are not significant to the cluster as a whole would not necessarily be considered a significant deficiency in internal control over compliance.

Reporting on Internal Control

The auditor also has additional responsibilities in a single audit to report on internal control over compliance. The auditor's reporting responsibilities are discussed later in this lesson.

Comparison of Internal Control Responsibilities—GAAS, *Government Auditing Standards*, Single Audit Act Amendments, and the Uniform Guidance

Exhibit 2-2 compares the requirements to consider internal control under generally accepted auditing standards (GAAS), *Government Auditing Standards*, the Single Audit Act Amendments, and the Uniform Guidance.

Exhibit 2-2

Comparison of Internal Control Responsibilities

	Fieldwork Responsibilities	Reporting Responsibilities
Generally accepted auditing standards	The auditor should obtain an understanding of internal control over financial reporting sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures. The auditor should understand both the design of controls relevant to an audit of financial statements and whether they have been implemented. [AU-C 315] The auditor should design and perform further audit procedures in response to the assessed risks of material noncompliance. Such procedures should include performing tests of controls over compliance if (a) the auditor's risk assessment includes an expectation of the operating effectiveness of controls over compliance for the applicable (i.e., direct and material) compliance requirements, (b) substantive procedures alone do not provide sufficient appropriate audit evidence, or (c) tests of controls over compliance are required by the governmental audit requirement (i.e., a requirement established by law, regulation, rule, or provision of contracts or grant agreements for an entity to undergo an audit of its compliance with applicable compliance requirements related to government programs). [AU-C 935.20]	The auditor should evaluate control deficiencies identified during the audit and communicate in writing to management and those charged with governance all significant deficiencies or material weaknesses, in accordance with generally accepted auditing standards.

	Fieldwork Responsibilities	Reporting Responsibilities
Government Auditing Standards	The auditor should communicate pertinent information that in his or her professional judgment needs to be communicated to individuals contracting for or requesting the audit, and to cognizant legislative committees when auditors perform the audit pursuant to a law or regulation, or they conduct the work for the legislative committee that has oversight of the audited entity. (Yellow Book, para. 4.03)	The auditor should issue a written report describing the scope of the auditor's testing of internal control over financial reporting and presenting the results of those tests. The report should also state whether the tests the auditor performed provided sufficient, appropriate evidence to support an opinion on the effectiveness of internal control. (An opinion on internal control over financial reporting is not required, but is permitted if sufficient work was performed.) (Yellow Book, paras. 4.19–.21) The auditor's report should identify deficiencies in internal control considered to be significant deficiencies and material weaknesses. (Yellow Book para. 4.23)
Single Audit Act and Uniform Guidance	With regard to internal control over federal awards, the auditor must: (1) perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk of noncompliance for major programs, (2) plan the testing of internal control over compliance for major programs to support a low assessed level of control risk of noncompliance for the assertions relevant to the compliance requirements for each major program,[a] and (3) perform tests of internal control as planned (unless internal controls over some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance).	The auditor must provide a written report on internal control over compliance describing the scope of testing of internal control over compliance and the results of the tests, and, where applicable, referring to a separate schedule of findings and questioned costs.

Note:

[a] The Uniform Guidance requires the auditor to plan the audit to support a low assessed level of control risk of noncompliance for major programs; however, it does not actually require the achievement of a low assessed level of control risk of noncompliance.

* * *

Documentation

Auditors are required to document their understanding of the internal control components that was obtained to plan the audit and the basis for their conclusions about the assessed level of control risk related to internal control over compliance for major programs. If the auditor has not performed tests of controls relevant to certain requirements or programs, the rationale for omitting such tests needs to be documented. In addition, AU-C 935.39–.40 indicates the auditor should document (a) the risk assessment procedures performed, including those related to gaining an understanding of internal control over compliance and (b) his or her responses to the assessed risks of material noncompliance (which includes control risk of noncompliance), the procedures performed to test compliance with

the applicable compliance requirements, and the results of those procedures, including any tests of controls over compliance. The GAS/SA Audit Guide, Paragraphs 9.60–.61, indicate that the following should be documented:

- The discussion among the engagement team regarding the susceptibility of the major programs to material noncompliance with the direct and material compliance requirements, including (a) how and when the discussion took place, (b) subject matters discussed, (c) which engagement team members participated, and (d) significant decisions reached on planned responses to compliance requirements.
- Key elements of the understanding obtained for each aspect of the entity and its environment as it relates to internal control over compliance, the sources of information from which the understanding was obtained, and the risk assessment procedures performed.
- The identified and assessed risks of material noncompliance.
- The risks identified and related controls about which the auditor obtained an understanding.
- Overall responses to address the assessed risks of noncompliance related to compliance requirements of major programs.
- The nature, timing, and extent of further audit procedures.
- The linkage of those procedures with the assessed risks.
- The results of the audit procedures.

An Emphasis Point at Paragraph 9.38 of the GAS/SA Audit Guide points out that some quality control reviews performed by federal agencies had findings in which auditors using dual purpose testing did not clearly identify the procedures performed to test compliance versus procedures used to test the operating effectiveness of internal control over compliance. Documentation for dual purpose tests needs to separately identify the two types of tests and the results of those tests. Documentation could be in various forms, such as narratives, tick marks, attribute descriptions, or similar notations.

The AICPA has been using data collected during peer reviews to identify audit issues and ultimately provide auditors with tools to improve the quality of their audits. Findings related to single audits included the following:

- Failure to document an understanding of internal control over federal awards sufficient to plan the audit to support a low assessed level of control risk of noncompliance for major programs, including consideration of risk of material noncompliance related to each compliance requirement and major program.
- Failure to document the testing of internal controls and compliance for the relevant assertions related to each compliance requirement with a direct and material effect for the major program.

Responsibility for Internal Control over Compliance for Programs That Are Not Major

Paragraph 9.09 of the GAS/SA Audit Guide states that "the auditor has no responsibility under the Uniform Guidance to obtain an understanding of internal control over compliance for programs that are not considered major or to plan or perform any related testing of internal control over compliance for those programs except for any procedures the auditor may choose to perform as part of the risk assessment process in determining major programs." The GAS/SA Audit Guide notes that these programs could still be material to the entity's financial statements. In that case, the auditor may need to obtain an understanding of internal control over financial reporting for the program as part of the financial statement audit.

DETERMINING WHICH CONTROLS TO TEST

Testing internal control over compliance is required in a Uniform Guidance audit of compliance regardless of whether the auditor tests controls 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 does the following:

- Gains an understanding of the applicable compliance requirements for each of the major programs. (Parts 2 and 7 of the *OMB Compliance Supplement* provide guidance on determining applicable compliance requirements.)
- Determines which compliance requirements have a direct and material effect on the major program.
- Determines the applicable controls for those compliance requirements.
- Determines what controls are in place to prevent or detect material noncompliance.
- Documents and plans tests of those controls to support a low assessed level of control risk of noncompliance.

The requirement to obtain an understanding of, plan, and test internal control over compliance to support a low assessed level of control risk of noncompliance applies only to internal control relevant to major federal programs. It does not apply to activities unrelated to federal awards or to activities related to nonmajor federal programs. For example, a city's water and sewer proprietary fund might not receive or expend any federal funds. If that fund has a separate internal control process related to its activities, it would not have to be addressed for purposes of auditing federal programs.

Multiple Internal Control Processes

Many control procedures may relate only to one program. However, other controls may relate to several or all of the major programs. For example, controls relating to the payment of invoices that are typically tested using a sample may apply to all of the programs. In those instances, it may be possible to perform the tests by selecting one overall sample that includes all of the major programs. Paragraph 11.42 of the GAS/SA Audit Guide explains that when internal control for a compliance requirement is common to more than one major program, the transactions of those programs could be combined into one population when determining sample sizes and selecting the sample for tests of internal controls. If the sample selected from the combined population does not include items from each major program, the auditor could judgmentally add items from programs not represented in the sample. Alternatively, the auditor could plan the initial combined sample to draw items from each major program. For example, if three major programs have common internal controls over the Allowable Costs/Cost Principles compliance requirement and the auditor plans to select a combined sample of 60 items, and the programs are of similar size, the auditor might select 20 items from each of the three major programs. If the major programs are not of similar size, the sample might be allocated proportionately.

Ineffective Internal Control

As discussed earlier in this lesson, OMB recognizes that in some situations, planning for and performing tests of controls to support a low assessed level of control risk of noncompliance may not be appropriate. When the auditor has determined that internal control for some or all of the types of compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, it is not necessary to plan and perform tests of internal control over compliance for those compliance requirements. The OMB requires, however, that the auditor report the internal control deficiency as a significant deficiency or a material weakness in internal control over compliance in the schedule of findings and questioned costs, assess control risk at the maximum, and consider whether additional compliance tests are required due to ineffective internal control. A footnote to Paragraph 9.32 of the GAS/SA Audit Guide states that it is not acceptable for the auditor to simply deem control risk to be "at the maximum" unless the auditor has a basis for determining why internal control over compliance is likely to be ineffective.

Auditors need to 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 having someone verify eligibility of individuals to participate in a program.

Paragraph 9.33 of the GAS/SA 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. For example, if a lack of segregation of duties causes controls over compliance with requirements for eligibility to be ineffective, the auditor would:

- Report the lack of segregation of duties relative to eligibility as a significant deficiency or a material weakness in internal control over compliance.
- Assess control risk of noncompliance 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.

Using Results of Prior Years' Tests of Controls

Because of the Uniform Guidance requirement to perform the testing of internal control to support a low assessed level of control risk of noncompliance, internal controls over compliance for federal programs should be tested each year. However, the results of prior years' tests of controls might provide important information to consider when planning current year tests of controls. If the results of prior tests of controls prevented the auditor from assessing a low level of control risk of noncompliance, the auditor might decide to expand testing in the current audit period. Useful information also might be obtained by testing changes in internal control that were intended to eliminate deficiencies noted in the previous year. However, if the auditor concluded in the prior year that internal control over compliance for one or more compliance requirements was ineffective and the auditee has not made changes in its internal control over compliance, the auditor might conclude that controls are likely to be ineffective. In this situation, the auditor could choose not to plan and perform tests of controls and must report a significant deficiency or a material weakness in internal control over compliance.

The results of prior years' internal control tests might not be relevant to tests of internal control when planning the current year's audit in the year an entity implements changes for the Uniform Guidance. The GAS/SA Audit Guide, at Paragraph 9.66, explains that nonfederal entities may have changed or updated their internal controls over compliance to a greater extent than normal as part of their process of implementing the Uniform Guidance. While the auditor should consider those changes when obtaining an understanding of internal control over compliance, assessing risk, and testing controls, the results of the prior year tests might not be relevant to the current year's audit.

Using Compliance Audit Testwork to Reduce Testwork in the Financial Statement Audit

The auditor may also consider how the testwork necessary for performing the compliance audit might contribute to the financial statement audit. For example, an entity may have one internal control process for handling payroll transactions. If the auditor tests the controls over payroll as part of the compliance audit, the auditor could consider that testwork when determining what additional tests of controls or other substantive procedures are necessary as part of the financial statement audit. The auditor may also choose to design tests of controls so that transactions from the entity's nonfederal program activities are selected for testing at the same time as the federal program transactions. As long as the compliance audit requirements are met, this method of testing may allow the auditor to be more efficient and maximize the audit evidence obtained from the tests of controls.

TESTING THE OPERATING EFFECTIVENESS OF CONTROLS

Although the Uniform Guidance requires the auditor to perform tests of controls to support a low assessed level of control risk of noncompliance, it does not give specific guidance on performing tests of the design or operating effectiveness of controls. Generally accepted auditing standards make the following points:

- Procedures directed toward evaluating the design of a control ordinarily include inquiries of appropriate entity personnel, inspection of documents and reports, observation of the application of specific controls, and tracing transactions through the information system relevant to financial reporting. Inquiry alone is not sufficient (AU-C 315.14 and AU-C 315.A75–.A76).

- Only those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in a relevant assertion need to be tested for operating effectiveness (AU-C 330.A21).

- Tests of the operating effectiveness of controls are concerned with how the control (whether manual or automated) was applied, the consistency with which it was applied during the audit period, and by whom or by what means it was applied (AU-C 330.10).

- These tests ordinarily include procedures such as inquiries of appropriate personnel, inspection of documents, reports, or electronic files indicating performance of the control, observation of the application of the control, and reperformance of the application of the control (AU-C 330.A28).

- Some of the procedures performed to evaluate the design of controls and determine that they have been implemented may also provide audit evidence about operating effectiveness and function as tests of controls (AU-C 330.A23).

- Generally, IT processing is inherently consistent. For this reason, procedures performed to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness (AU-C 315.A77).

- The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls (AU-C 330.A28).

- The nature of a control will generally direct the type of audit procedure necessary to obtain evidence about its operating effectiveness. If documentation of the operation of a control exists, the auditor might inspect the documentation. If documentation of the operation does not exist, the auditor might obtain audit evidence about the control's operating effectiveness through inquiry in combination with other audit procedures such as observation or the use of Computer Assisted Audit Techniques (CAATs) (AU-C 330.A29).

- Controls should be tested for either a particular time or throughout the period of intended reliance, depending upon the circumstances. For example, when testing controls over a year-end physical inventory count, the auditor needs audit evidence of the control's operating effectiveness only at that period of time (AU-C 330.11 and AU-C 330.A35).

The guidance described above is written from the perspective of a financial statement audit; however, it is generally applicable when testing internal control over compliance. AU-C 935, which explains how GAAS is adapted and applied in a compliance audit, provides additional guidance on tests of controls. AU-C 935.19–.20 requires the auditor to design and perform further audit procedures in response to the assessed risks of material noncompliance. Such procedures should include performing tests of controls over compliance if any of the following conditions are met:

- The auditor's risk assessment includes an expectation of the operating effectiveness of controls over compliance for the applicable compliance requirements.

- Substantive procedures alone do not provide sufficient appropriate audit evidence.

- Tests of controls over compliance are required by the governmental audit requirement.

AU-C 935.A25 further clarifies that some governmental audit requirements, such as OMB Circular A-133 (now replaced by the Uniform Guidance), require tests of the operating effectiveness of controls identified as likely to be effective, even if the auditor believes that such testing would be inefficient.

Auditors need to note that AU-C 330.11 states that controls should be tested for the particular time, or throughout the period, for which the auditor intends to rely on those controls in order to have an appropriate basis for the intended reliance. Although auditors are allowed to place some reliance on tests of controls performed in prior years, Paragraph 9.30 of the GAS/SA Audit Guide indicates that because of the Uniform Guidance requirement to perform the testing of internal control to support a low assessed level of control risk of noncompliance, internal controls over compliance for federal programs should be tested each year. In addition, AU-C 935 indicates that the paragraphs of AU-C 330 that address the use of audit evidence obtained in prior audits related to testing the operating effectiveness of controls (and the rotation of such testing) (i.e., AU-C 330.13–.14) are not applicable to a compliance audit. Therefore, Paragraph 9.37 of the GAS/SA Audit Guide also indicates that in a Uniform Guidance compliance audit, controls that address the risks of noncompliance with direct and material compliance requirements for major programs should be tested every year.

Extent of Tests of Controls

AU-C 330.09 indicates that when the auditor designs and performs tests of controls, the auditor should obtain more persuasive audit evidence as the reliance the auditor places on the effectiveness of a control increases. AU-C 330.A31 further explains that the extent of tests of controls necessary in particular circumstances is affected by the degree of assurance provided by a test procedure in relation to the degree of assurance needed to support a control risk assessment.

The GAS/SA Audit Guide, in Paragraph 9.31, states that in a Uniform Guidance compliance audit, and assuming an understanding that controls are effective, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence that the controls are operating effectively for each direct and material compliance requirement for each major program throughout the period of reliance. In doing so, the auditor might consider the following factors (AU-C 330.A31):

- The frequency with which the control is performed during the period.
- The length of time that the auditor is relying on the control's operating effectiveness.
- The expected deviation from the control.
- The relevance and reliability of the audit evidence about operating effectiveness of the control with respect to the type of compliance requirement being considered.
- The extent to which audit evidence is obtained from tests of other controls related to the type of compliance requirement.

Paragraph 9.31 of the GAS/SA Audit Guide indicates that, when designing and performing tests of controls, the auditor should obtain more persuasive audit evidence when the auditor plans to place greater reliance on the operating effectiveness of a control. The extent of internal control testing should also increase as the expected deviation increases. However, the auditor should consider whether the rate of expected deviation indicates that performing tests of controls will not provide sufficient audit evidence to reduce the control risk of noncompliance for the assertions relevant to the compliance requirement. If the rate of expected deviation for a particular type of compliance requirement is expected to be high, the auditor might determine that tests of controls are inappropriate.

Multipurpose Tests and Sampling in Tests of Controls

Paragraph 9.38 of the GAS/SA Audit Guide indicates that a test of controls might be performed concurrently with a test of details on the same transactions. Although the purposes of the tests are different, they can be accomplished concurrently by performing a test of controls and a test of details on the same transaction (a dual purpose test). For

example, the auditor might examine an invoice both to determine whether it was approved and whether it provides substantive evidence of a transaction. A dual purpose test is designed and evaluated by considering each purpose of the the test separately. Also, when performing the tests, Paragraph 9.38 indicates that the auditor should consider how the outcome of the test of controls might affect the extent of the auditor's substantive procedures.

Audit sampling is not required for tests of controls, but it may be used and can be very efficient. As discussed above, an effective approach may be to perform tests of controls that involve sampling simultaneously with tests of compliance with laws and regulations (a dual-purpose test). Additionally, these tests may, in some instances, also serve as a substantive test of one or more account balances (a triple-purpose test). Audit procedures designed to test compliance with federal statutes, regulations, and the terms of conditions of the federal award for expenditures charged to major federal award programs will simultaneously test the operating effectiveness of control activities designed to ensure compliance with those statutes, regulations, and the terms of conditions of the award. In some cases, there is no real distinction between tests of compliance with program requirements and tests of controls over program requirements. Paragraph 11.52 of the GAS/SA Audit Guide states that the sample size for a dual purpose, test will usually be the larger of the one that would be used if the control and compliance samples were tested separately. Also, tests of controls and tests of compliance should be documented separately so there is a clear distinction between the audit objectives and test results for each test and to enable separate conclusions to be reached on the internal control attributes and compliance attributes tested.

Auditors need to exercise caution when performing and documenting dual purpose testing. An Emphasis Point at Paragraph 9.38 of the GAS/SA Audit Guide points out that some quality control reviews performed by federal agencies had findings that auditors using dual purpose testing did not clearly identify the procedures performed to test compliance versus procedures used to test internal control over compliance. Documentation for dual purpose tests needs to separately identify the two types of tests and the results of those tests.

Evaluating the Results of Tests of Controls

Paragraph 9.39 of the GAS/SA Audit Guide explains that the auditor should evaluate whether the assessment of the risk of material noncompliance for the relevant compliance requirements remains appropriate based on the audit procedures performed related to controls and the audit evidence obtained. The audit evidence may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information coming to the auditor's attention may differ significantly from the information on which the risk assessments were based.

Before the conclusion of the audit, the auditor should evaluate whether audit risk of noncompliance has been reduced to an appropriately low level, and whether the nature, timing, and extent of the audit procedures need to be reconsidered. The auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce the risks of material noncompliance to an appropriately low level. In developing an opinion on compliance, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the relevant assertions.

Paragraph 9.40 of the GAS/SA Audit Guide indicates that in situations where auditors cannot support a low assessed level of control risk of noncompliance for a direct and material compliance requirement for a major program, they are not required to expand their testing of internal control over compliance for that compliance requirement. Instead, they may choose not to perform additional tests of controls. It further indicates "in that situation, the auditor would assess control risk of noncompliance at other than low, design tests of compliance accordingly, and consider the need to report an audit finding." If auditors decide to expand their testing of internal control over compliance, their decision would be based on whether they consider the additional internal control testing to be more efficient than performing additional tests of compliance. Paragraph 9.42 of the GAS/SA Audit Guide notes that based on the testing performed, control risk of noncompliance might be assessed at less than maximum to reduce substantive tests of compliance. If it cannot be assessed at less than the maximum, it might be more appropriate to assess control risk of noncompliance at the maximum.

It is natural for there to be some deviations in the way controls are applied. A control that has a non-negligible deviation rate is, at minimum, a deficiency in internal control over compliance regardless of the reason for the deviation. When deviations are detected during the performance of tests of controls, the auditor should make specific inquiries to understand the deviations and their potential consequences. In addition, the auditor should consider whether any noncompliance detected from performing substantive procedures changes his or her

judgment about the effectiveness of the related controls. The auditor also should not assume that an instance of fraud or error is an isolated occurrence, and should consider how it affects the assessed risk of material noncompliance.

Because effective controls can reduce but not eliminate risks of material noncompliance, tests of controls can reduce but not eliminate the need for substantive procedures. Therefore, the auditor should design and perform substantive procedures for all relevant assertions related to the direct and material compliance requirements for each major program.

Tests of compliance may provide evidence that either supports the auditor's conclusion about the operating effectiveness of controls or creates a need to reevaluate the prior assessment of control risk of noncompliance. The GAS/SA Audit Guide, Paragraph 9.44, states that the auditor should consider the results of tests of compliance when evaluating the operating effectiveness of internal control over compliance. Noncompliance detected by the auditor that was not identified by the entity is evidence of a deficiency in internal control over compliance and might indicate a significant deficiency or a material weakness in internal control over compliance. For example, if a test of compliance indicates that equipment was charged to a major program but the grant agreement for that program did not allow program funds to be spent on equipment, detection of this noncompliance would be relevant, reliable audit evidence about the ineffectiveness of the related internal control over compliance. On the other hand, a test of compliance that does not detect noncompliance does not provide audit evidence that controls related to a compliance requirement are effective.

Control Deficiencies. A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct noncompliance with a type of compliance requirement on a timely basis. The auditor should evaluate the severity of each deficiency in internal control over compliance to determine whether the deficiency, individually or in combination, is a significant deficiency or material weakness in internal control over compliance. The severity of a deficiency depends on the magnitude of potential noncompliance and whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, noncompliance with a type of compliance requirement.

The GAS/SA Audit Guide, Paragraph 9.52, explains that the evaluation of deficiencies in internal control over compliance includes the magnitude of potential noncompliance. (Note that the auditor considers the *potential* for noncompliance, not whether noncompliance has occurred. The absence of identified noncompliance does not indicate that control deficiencies are not significant deficiencies or material weaknesses in internal control over compliance.) Factors that affect the magnitude of potential noncompliance that could result from deficiencies in controls are discussed below.

As discussed below, the auditor should evaluate individual control deficiencies that affect the type of compliance requirement, or component of internal control, to determine if they collectively result in a significant deficiency or material weakness in internal control over compliance because a combination of control deficiencies that affect the same type of compliance requirement increase the risks of material noncompliance.

AU-C 935.11 defines *material weakness in internal control over compliance* and *significant deficiency in internal control over compliance* for the purposes of reporting on internal control over compliance. Paragraph 9.47 of the GAS/SA Audit Guide further adapts the AU-C 935.11 definitions for reporting on internal control over compliance in a Uniform Guidance audit as follows:

- *Material weakness in internal control over compliance.* A deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

- *Significant deficiency in internal control over compliance.* A deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Paragraph 9.51 of the GAS/SA Audit Guide provides the following examples of risk factors that affect whether there is a reasonable possibility that a deficiency, or combination of deficiencies, will result in noncompliance with a type of compliance requirement of a federal program:

- The nature of the type of compliance requirement involved. For example, a specific special test or provision might involve greater risk because it is unique to the program and may require unique controls.
- The susceptibility of the program and related types of compliance requirements to fraud.
- The subjectivity and complexity involved in meeting the compliance requirement, and the extent of judgment required in determining noncompliance.
- The interaction or relationship of the control with other controls.
- The interaction among the deficiencies.
- Possible future consequences of the deficiency.

Paragraph 9.52 of the GAS/SA Audit Guide provides the following examples of factors that may affect the *magnitude* of potential noncompliance:

- The program amounts or total of transactions exposed to the deficiency relative to the type of compliance requirement.
- The volume of activity related to the compliance requirement exposed to the deficiency in the current period or expected in future periods.
- Adverse publicity or other qualitative factors.

Paragraph 9.53 of the GAS/SA Audit Guide indicates that because controls may be designed to operate individually or in combination, an individual deficiency in internal control over compliance might not be sufficiently important to be considered a material weakness or significant deficiency. However, a combination of deficiencies affecting the same type of compliance requirement or component of internal control over compliance increase the risks of material noncompliance to such an extent that they create a significant deficiency or material weakness in internal control over compliance, even if the individual deficiencies are less severe. Thus, the auditor should determine whether deficiencies affecting the same type of compliance requirement or component of internal control collectively result in a significant deficiency or material weakness in internal control over compliance.

Paragraph 9.54 of the GAS/SA Audit Guide explains that for a control that does not operate effectively, management may inform the auditor, or the auditor may otherwise become aware, of the existence of compensating controls that, if effective, may limit the severity of the deficiency and prevent it from being a significant deficiency or material weakness in internal control over compliance. Although not required to do so, the auditor may consider the effects of compensating controls related to a deficiency in operation if such controls were tested for operating effectiveness. However, while compensating controls can limit the severity of the deficiency, they do not eliminate it.

If the auditor determines that a deficiency, or a combination of deficiencies, is not a material weakness in internal control over compliance, he or she should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion.

Paragraph 9.57 of the GAS/SA Audit Guide provides the following examples of indicators of material weaknesses in internal control over compliance:

- Fraud of any magnitude on the part of senior program management that affects a major program is identified. (For purposes of evaluating and communicating deficiencies in internal control over compliance, the auditor should evaluate fraud of any magnitude of which he or she is aware on the part of senior program management, including fraud resulting in immaterial noncompliance.)

- Material noncompliance is identified in circumstances that indicate it would not have been detected by the entity's internal control (for example, the noncompliance was not initially identified by the entity's internal control).

- Oversight by management, or those charged with governance, over compliance with program requirements where the activity is subject to a type of compliance requirement is ineffective (for example, federal financial reports are not adequately reviewed before being submitted to the grantor).

THE AUDITOR'S REPORTING RESPONSIBILITIES

When auditors report on internal control over compliance for federal programs, they should consider the definitions of a significant deficiency in internal control over compliance and a material weakness in internal control over compliance discussed in the previous section.

For Uniform Guidance compliance audit purposes, Paragraph 9.48 of the GAS/SA Audit Guide explains that the determination of whether a deficiency in internal control over compliance is a significant deficiency or material weakness for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program identified in the Compliance Supplement. The controls that auditors are concerned with are those that relate to assuring compliance or, in other words, preventing noncompliance. Accordingly, auditors need to evaluate significant deficiencies and material weaknesses relative to the levels of materiality considered for the related major programs.

In a Uniform Guidance audit of compliance, the primary objective of the consideration of internal control may not be to reduce the extent of substantive audit tests based on the effectiveness of control activities, but to report on internal control. Though the Single Audit Act and the Uniform Guidance require a report on the internal control over federal awards, they do not require the auditor to express an opinion on internal control. (However, auditors are required to express an opinion on compliance.)

2 CFR sections 200.515(b) and 200.515(c) give the following guidance concerning the report content:

- *2 CFR section 200.515(b):* A report on internal control over financial reporting and compliance with provisions of laws, regulations, contracts, and award agreements, noncompliance with which could have a material effect on the financial statements . . . must describe the scope of testing of internal control and compliance and the results of the tests, and, where applicable, it will refer to the separate schedule of findings and questioned costs described in [2 CFR section 200.515(d)].

- *2 CFR section 200.515(c):* A report on compliance for each major program and a report on internal control over compliance . . . must describe the scope of testing of internal control over compliance, include an opinion or disclaimer of opinion as to whether the auditee complied with Federal statutes, regulations, and the terms and conditions of Federal awards which could have a direct and material effect on each major program and refer to the separate schedule of findings and questioned costs described in [2 CFR section 200.515(d)].

The schedule of findings and questioned costs must include disclosure of significant deficiencies and material weaknesses at the financial statement level and at the major program level.

In addition to the report described in the preceding paragraph, the Single Audit Act requires that the auditor follow the GAO's Yellow Book. The Yellow Book requires a report on internal control in relation to the audit of the financial statements. This means that the auditor must disclose any significant deficiencies and material weaknesses identified during the financial statement audit as a result of the consideration of internal controls or any other audit tests.

SELF-STUDY QUIZ

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

20. Which of the following would an auditor do related to internal control for a single audit that would not be necessary during a regular audit?

    a. Make inquiries of the entity's personnel.

    b. Report on internal control over compliance.

    c. Observe specific controls application.

    d. Trace transactions through the financial reporting system.

21. Under what circumstances should an auditor perform tests of controls over compliance?

    a. The auditor can obtain enough information using only substantive procedures.

    b. The engagement being performed is a single audit.

    c. Controls over compliance for immaterial compliance requirements are expected to operate effectively.

    d. After risks of noncompliance have already been assessed.

22. Which of the following auditors has correctly addressed an issue related to tests of controls in a Uniform Guidance compliance audit?

    a. Ethan disregards the prior year tests of his client's controls since such testing is required to be done every year.

    b. Francine performs tests of controls using one overall sample that applies to all of her client's major programs.

    c. George reperforms all tests of controls related to the financial reporting system during his client's compliance audit.

    d. Holly uses results from tests of controls performed during her client's financial statement audit to provide evidence for the client's compliance audit.

23. When performing tests of controls in a Uniform Guidance compliance audit, the auditor may consider which of the following?

    a. The length of time the control has been in use.

    b. How often the control was performed during the prior year versus the current year.

    c. The amount of deviation expected from the control.

    d. Assuming that the controls are ineffective for their designed purpose.

24. Which of the following exists if either the design or the operation of a control over compliance does not allow employees or management to prevent (or detect and correct) noncompliance on a timely basis while performing their normal, assigned functions?

    a. Deficiency in internal control over compliance.

    b. Non-negligible deviation rate.

    c. Material weakness in internal control over compliance.

    d. Significant deficiency in internal control over compliance.

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.)**

20. Which of the following would an auditor do related to internal control for a single audit that would not be necessary during a regular audit? **(Page 239)**

    a. Make inquiries of the entity's personnel. [This answer is incorrect. Per AU-C 315.A76, this is a procedure that auditors may use to obtain audit evidence about the design and implementation of relevant controls, which makes it applicable to all audits, not just single audits.]

    b. Report on internal control over compliance. [This answer is correct. In addition to GAAS and *Government Auditing Standards* requirements, the Uniform Guidance states that the auditor must do several additional things, including performing procedures to obtain an understanding of internal control over federal programs sufficient to plan the audit to support a low assessed level of control risk of noncompliance for major programs and performing tests of internal control over compliance as planned.]

    c. Observe specific controls application. [This answer is incorrect. As described in AU-C 315.A76, observation of the application of specific controls is something that auditors will do in all audits, so it is not specific to single audits.]

    d. Trace transactions through the financial reporting system. [This answer is incorrect. Tracing transactions through the information system relevant to financial reporting is a procedure used to obtain audit evidence for any audit, not only a single audit. Such procedures are discussed in AU-C 315.A76.]

21. Under what circumstances should an auditor perform tests of controls over compliance? **(Page 241)**

    a. The auditor can obtain enough information using only substantive procedures. [This answer is incorrect. According to the GAS/SA Audit Guide, an auditor's procedures should include performing tests of controls over compliance when substantive procedures alone do *not* provide sufficient appropriate audit evidence. If the substantive procedures alone do provide enough evidence, barring other information, the auditor may not need to perform tests of controls over compliance.]

    b. The engagement being performed is a single audit. [This answer is correct. Paragraph 9.15 of the GAS/SA Audit Guide explains that AU-C 935.20 requires the auditor to design and perform further audit procedures in response to the assessed risks of material noncompliance. The auditor's procedures should include performing tests of controls over compliance in certain specific circumstances, such as when tests of controls over compliance are required by the governmental audit requirement. This is true for single audit engagements.]

    c. Controls over compliance for immaterial compliance requirements are expected to operate effectively. [This answer is incorrect. Based on the guidance provided in the GAS/SA Audit Guide, auditors need to perform tests of controls over compliance when the risk assessment includes an expectation that controls over compliance related to direct and *material* requirements are operating effectively. It may not be necessary if the only requirement to be tested is immaterial.]

    d. After risks of noncompliance have already been assessed. [This answer is incorrect. According to Paragraph 9.16 of the GAS/SA Audit Guide, the auditor might perform procedures for gaining an understanding of internal control over compliance concurrently with assessing the risks noncompliance. Therefore, it is not mandatory that the auditor wait until after such risks have been assessed to perform the tests of controls.]

22. Which of the following auditors has correctly addressed an issue related to tests of controls in a Uniform Guidance compliance audit? **(Page 253)**

    a. Ethan disregards the prior year tests of his client's controls since such testing is required to be done every year. [This answer is incorrect. Because of the Uniform Guidance requirement to perform the testing of internal control to support a low assessed level of control risk of noncompliance, internal controls over compliance for federal programs should be tested each year. However, the results of prior years' tests of controls might provide important information to consider when planning current year tests of controls. If the results of prior tests of controls prevented the auditor from assessing a low level of control risk of noncompliance, the auditor might decide to expand testing in the current period. Therefore, by ignoring the former tests, Ethan may miss some important information that could affect his audit.]

    b. Francine performs tests of controls using one overall sample that applies to all of her client's major programs. [This answer is correct. Many control procedures relate only to one program. However, other controls may relate to several or all of the major programs (e.g., controls relating to the payment of invoices). In those instances, it may be possible to perform the tests by selecting one overall sample that includes all of the major programs. This is discussed in Paragraph 11.42 of the GAS/SA Audit Guide; therefore, Francine is in compliance with appropriate authoritative guidance when testing controls in this manner.]

    c. George reperforms all tests of controls related to the financial reporting system during his client's compliance audit. [This answer is incorrect. 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. Therefore, George is overauditing.]

    d. Holly uses results from tests of controls performed during her client's financial statement audit to provide evidence for the client's compliance audit. [This answer is incorrect. Testing internal control over compliance is required in a Uniform Guidance audit of compliance regardless of whether the auditor tests controls in the audit of the financial statements. Therefore, Holly will need to test additional controls to be in compliance with this guidance.]

23. When performing tests of controls in a Uniform Guidance compliance audit, the auditor may consider which of the following? **(Page 256)**

    a. The length of time the control has been in use. [This answer is incorrect. According to AU-C 330.A31, an auditor may consider the length of time that the auditor is relying on the control's operating effectiveness, but the length of time that the client has been using the control does not factor into the consideration.]

    b. How often the control was performed during the prior year versus the current year. [This answer is incorrect. As described in AU-C 330.A31, one factor an auditor might consider in this situation is the frequency with which the control is performed during the period. How often the control was performed in a year not covered by the compliance audit is not a factor for this consideration.]

    c. The amount of deviation expected from the control. [This answer is correct. When performing tests of controls, AU-C 330.A31 presents certain factors that the auditor should consider. One such factor is the expected deviation from the control. Another is the relevance and reliability of the audit evidence about operating effectiveness of the control with respect to the type of compliance requirement being considered.]

    d. Assuming that the controls are ineffective for their designed purpose. [This answer is incorrect. The GAS/SA Audit Guide, in Paragraph 9.31, states that in a Uniform Guidance compliance audit, and assuming that controls are effective, the auditor should design and perform tests of controls to obtain sufficient and appropriate audit evidence that the controls are operating effectively for each direct and material compliance requirement for each major program throughout the period of reliance. Therefore, per this guidance, when performing tests of controls, the auditor's assumption should be that the controls are effective, not that they are ineffective.]

24. Which of the following exists if either the design or the operation of a control over compliance does not allow employees or management to prevent (or detect and correct) noncompliance on a timely basis while performing their normal, assigned functions? **(Page 258)**

    a. **Deficiency in internal control over compliance. [This answer is correct. A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct noncompliance with a type of compliance requirement on a timely basis. The auditor should evaluate the severity of each deficiency in internal control over compliance to determine whether the deficiency, individually or in combination, is a significant deficiency or material weakness in internal control over compliance.]**

    b. Non-negligible deviation rate. [This answer is incorrect. It is natural for there to be some deviations in the way controls are applied. A control that has a *non-negligible deviation rate* is, at a minimum, a deficiency in internal control over compliance regardless of the reason for the deviation. However, this is a different concept than the one described above.]

    c. Material weakness in internal control over compliance. [This answer is incorrect. This is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. While this concept is related to the one described above, it is slightly different, so there is a better answer to this question.]

    d. Significant deficiency in internal control over compliance. [This answer is incorrect. This is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance. This concept is related to the one described above, but there is a better answer choice, as the concepts have subtle differences.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Single Audits—Course 2—Pre-engagement Activities and Internal Control Considerations (GSATG172)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This 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 the course, 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.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com**/**ogs** 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 of $89 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 email, mail, or fax your completed answer sheet, as described below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products; they can also be scanned for email grading, if desired. 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. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     GSATG172 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with 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 the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you

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6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Single Audits—Course 2—Pre-engagement Activities and Internal Control Considerations (GSATG172)

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. Most component units will do which of the following?

   a. Be classified as a nonprofit organization.

   b. Undergo their own single audit.

   c. Present blended financial information.

   d. Use the discrete presentation for their financial information.

2. *Blending* would be used in which of the following situations?

   a. Primary Government A and Component Unit B have separate governing bodies.

   b. Primary Government C and Component Unit D have the same governing body and a financial benefit relationship.

   c. Primary Government E and Component Unit F have the same governing body, but Unit F is responsible for its own operations.

   d. Primary Government G and Component Unit H share their governing body, but Unit H is responsible for paying its own debts.

3. When might it be appropriate to use combined financial statements?

   a. Two organizations are under common control.

   b. One organization has both an economic interest in and control over another.

   c. One organization has an economic interest in another but no control over it.

   d. One organization has control over another organization but no economic interest in it.

4. Which of the following statements best describes an issue related to treating a component unit separately for single audit purposes?

   a. The audit must include both government-wide and component-specific financial statements.

   b. The component unit must be considered a legally separate entity under GASBS No. 14.

   c. The component unit must be considered a nonprofit organization.

   d. The component unit must be the same as the reporting entity defined under GAAP.

5. The publicity associated with a governmental audit makes consideration of which of the following especially important during the client acceptance process?

   a. The reputation of the potential client.

   b. Information provided by the predecessor auditor.

   c. The request for proposal (RFP) provided by the entity.

   d. Not having any management-imposed scope restrictions.

6. An auditor is required to consult which of the following sources when deciding whether to accept a prospective client?

   a. Other CPAs in the community.

   b. The predecessor auditor.

   c. The news media.

   d. The entity's public information office.

7. Who is responsible for determining whether a single audit is required?

   a. The auditor.

   b. Management.

   c. A governmental oversight body.

   d. There is no determination; all governmental entities need a single audit.

8. Grayson is considering whether to accept a governmental audit engagement. He has provided some nonaudit services to this entity in the past. What guidance should Grayson consult to determine whether he is independent from the entity and able to perform its governmental audit?

   a. The AICPA *Code of Professional Conduct.*

   b. The AICPA Audit and Accounting Guide, *State and Local Governments* (SLG).

   c. Statement on Quality Control Standards (SQCS) No. 8 (QC 10).

   d. *Government Auditing Standards* (the Yellow Book).

9. Which of the following will automatically impair an auditor's independence?

   a. Discussing the application of accounting standards with management.

   b. Preparing the governmental entity's financial statements.

   c. Preparing of source documents that evidence a transaction.

   d. Assisting management with its responsibilities.

10. If an auditor is able to perform an audit without having his or her professional judgment influenced and, therefore, can act with integrity and exercise both professional skepticism and objectivity, the auditor has what quality?

    a. Independence.

    b. Independence in appearance.

    c. Independence of mind.

    d. Competency.

11. According to the Yellow Book, the threat that an audit organization's position within the government and the configuration of that government could affect the organization's ability to conduct audit work and report objective results is called what?

    a. Familiarity threat.

    b. Management participation threat.

    c. Self-review threat.

    d. Structural threat.

12. Which of the following, if properly designed, can eliminate threats or reduce them to a level that is acceptable for the audit engagement?

    a. Acceptance and continuance policies and procedures.

    b. Management responsibilities.

    c. An RFP.

    d. Safeguards.

13. When deciding whether to accept a governmental audit engagement, the availability and qualifications of staff, locations to be covered, general knowledge of the government's environment, and communication skills are part of what?

    a. Competence requirements.

    b. Independence requirements.

    c. Quality control.

    d. Safeguards.

14. Monica has expertise in an area that is not accounting or auditing. She is engaged by an auditor to assist with an aspect of a governmental audit. Monica would be considered which of the following?

    a. Auditor's specialist.

    b. Management's specialist.

    c. Other specialist.

    d. A group auditor.

15. When a specialist is used in a governmental audit, who is responsible for the relevance and reasonableness of the specialist's findings?

    a. The specialist.

    b. The auditor.

    c. Management.

    d. The client's internal auditor.

16. The following auditors all hired specialists to work on their governmental audit engagements. Which one will most likely want to apply more extensive procedures relating to the specialist and/or the specialist's work?

    a. Alan's specialist worked on a significant finding that involved complex judgments.

    b. Beverly has worked with her specialist on several previous engagements and has a good sense of his competence.

    c. Carlos's specialist performs procedures that allow her to provide guidance on an individual matter.

    d. Dina's specialist is a member of her firm and subject to the same quality control procedures she is.

17. Which of the following statements best describes the annual evaluation for a continuing engagement?

    a. The annual evaluation is typically performed after the continuance decision has been made and the engagement has begun.

    b. It is more difficult to find information to use in the annual evaluation in subsequent years working with the same client.

    c. If information is discovered that would have caused the firm to decline the engagement previously, an engagement partner must inform his or her firm immediately.

    d. If, during previous engagements, the firm has found the client to be trustworthy and to have integrity, the annual evaluation can be omitted.

18. AU-C 210.10 specifies that an engagement letter should include which of the following?

    a. The responsibilities of both management and the auditor.

    b. A statement that any material misstatement will be detected.

    c. Identification of the financial reporting frameworks that would be acceptable for the financial statements.

    d. A statement assuring the client that they will receive an unmodified report.

19. An engagement letter for a single audit engagement would contain which of the following that is not included in other types of audits?

    a. A statement that Yellow Book auditing standards will be followed.

    b. A statement that the audit is not designed for detecting immaterial errors or fraud.

    c. A discussion of the auditor's responsibility for auditing major and minor programs.

    d. The objective of an audit performed under the Uniform Guidance.

20. For a single audit to be required, a nonfederal entity must expend a minimum of what amount of federal awards?

    a. $100,000.

    b. $500,000.

    c. $750,000.

    d. $1 million.

21. All of the following would be considered *federal financial assistance* **except**:

    a. Cooperative agreements.

    b. Food commodities.

    c. Medicare reimbursements.

    d. Interest subsidies.

22. The determination of when a federal award is expended is based on what?

    a. When the funds are awarded.

    b. When the related activity occurs.

    c. When the funds are budgeted.

    d. The end of the fiscal year.

23. Hamilton R&D, a nonprofit research organization, earns program income from federal award funds. No prior approval has been sought from the federal award agency. How should it treat the program income?

    a. Deduct it from total allowable costs.

    b. Add it to the federal award.

    c. Use it to meet cost sharing requirements.

    d. Use it to meet matching requirements.

24. Under what circumstances would an entity **not** need to undergo a single audit?

    a. The reporting entity is a pass-through entity.

    b. The award was issued by the National Institutes of Health (NIH).

    c. The only assistance received was loans or loan guarantees.

    d. The only assistance received was free rent.

25. The value expended of what type of noncash award is calculated as the cumulative balance of federal awards for this purpose that are federally restricted in each audit period that the funds are still restricted?

    a. Endowments.

    b. Free rent.

    c. Insurance.

    d. Loans and loan guarantees.

26. If no exceptions apply, how often do the Single Audit Act Amendments and 2 CFR section 200.504 specify that audits be performed?

    a. Annually, over the fiscal year.

    b. Annually, over the program year.

    c. Biennially, over both years.

    d. Every other year, over the most recent year.

27. When might a nonprofit organization or a governmental unit have its first audit (an initial audit)?

    a. When necessary per the SEC filing requirements.

    b. When required by the Uniform Guidance.

    c. When they meet a specific income threshold outlined in the Yellow Book.

    d. When it has a specific amount of terminated contracts and award programs.

28. What are the five elements of internal control?

    i. Compliance
    ii. Control environment
    iii. Control activities
    iv. Information and communication
    v. Monitoring
    vi. Professional judgment
    vii. Risk assessment
    viii. Safeguards

    a. i., ii., iii., v., and vi.

    b. i., iv., v., vi., and viii.

    c. ii., iii., iv., v., and vii.

    d. ii., iii., vi., vii., and viii.

29. A control that is capable of effectively detecting or correcting material misstatements or instances of noncompliance, either individually or in combination with others, has good what?

    a. Design.

    b. Documentation.

    c. Implementation.

    d. Information technology (IT).

30. Tara's governmental audit client has multiple controls that will help it achieve a certain control objective. How should Tara proceed?

    a. She must thoroughly test each control related to the control objective.

    b. She should focus her procedures on key controls identified by the client.

    c. She should focus her procedures on key controls that she identifies.

    d. She should perform procedures on a random sample of the controls.

31. An audit client's use of which of the following may impact the availability of information?

    a. Control objectives.

    b. IT.

    c. An IT specialist.

    d. Policy manuals.

32. Which element of internal control is considered the foundation for all other components of internal control?

    a. Control environment.

    b. Risk assessment.

    c. Information and communication.

    d. Control activities.

33. An entity's financial reporting system is part of which element of internal control?

    a. Control environment.

    b. Information and communication.

    c. Monitoring.

    d. Control activities.

34. What is the purpose of the auditor's evaluation of control design and implementation?

    a. To identify key controls for the five elements of internal control.

    b. To obtain an understanding of controls relevant to compliance with laws and regulations.

    c. To compare the differences between internal control under GAAS, the Yellow Book, the Single Audit Act, and the Uniform Guidance.

    d. To assess the risk of material misstatement of the financial statements.

35. An entity's internal control related to the compliance requirements for federal programs should provide reasonable assurance of which of the following?

    a. Accountability over assets is distributed and diversified among client personnel.

    b. The maximum number of people have access to funds, property, and other assets.

    c. Transactions comply with material federal statutes, regulations, and terms and conditions of federal awards.

    d. Transactions are recorded in a way that the client's management and those employed by the client can understand what they mean.

36. Which of the following statements best describes an issue about the auditor's understanding of internal control in a single audit?

    a. The auditor must be concerned with internal control over both the financial statements and compliance.

    b. Risk assessment procedures for this type of audit are completely different than those for a typical financial statement audit.

    c. If multiple organizational units administer the federal award programs, the auditor only has to obtain an understanding of the main unit's internal control.

    d. The 12 types of compliance requirements outlined in the Compliance Supplement do not apply to single audit engagements.

37. Which of the following auditors has correctly addressed an issue related to internal control in a compliance audit performed under the Uniform Guidance?

    a. Evelyn performs separate tests of internal controls for her compliance audit and her financial statement audit of the same entity, duplicating tests where necessary.

    b. Frank determines that internal control for a particular compliance requirement is likely to be ineffective and confirms that by planning and performing tests of internal control.

    c. Greta obtains enough of an understanding of internal control over compliance for nonmajor programs to be satisfied that there are no issues related to them.

    d. Howard documents his understanding of internal control and assessed control risk related to his client's internal control over compliance for major programs.

38. Which of the following would be most likely to increase the magnitude of potential noncompliance?

    a. A large number of transactions exposed to a control deficiency.

    b. A low rate of activity related to the deficiency expected in future years.

    c. An affected control that works independently of other controls.

    d. Positive publicity about the entity being audited unrelated to the deficiency.

39. The existence of which of the following could indicate a material weakness in internal control over compliance?

    a. Fraud by a low-level employee affected a minor program.

    b. Material noncompliance that would not be detected by internal control.

    c. Effective management oversight over compliance with program requirements.

    d. An immaterial deficiency in internal control over compliance.

40. John accepts an engagement to perform a compliance audit under the Uniform Guidance. How might this affect his report?

    a. He should include an opinion or disclaimer about whether his client complied with federal statutes, regulations, and terms and conditions of federal awards.

    b. Because his audit must comply with the Single Audit Act, he is exempt from complying with requirements in the Yellow Book.

    c. He should include a disclosure of significant deficiencies and material weaknesses of each of his clients programs.

    d. He will be required to express an opinion on his client's compliance and its internal control.

GLOSSARY

Aggregation risk: Audit risk that results from the aggregation of component financial information.

Auditor's specialist: Individuals or organizations that possess expertise in an area other than accounting or auditing whose work is used by the auditor. They can either be an internal specialist within the auditor's firm or a network firm or can be an external specialist.

Blending: A financial reporting method for *component units* that are so closely related to the primary government that they are, in effect, the same as the primary government. Under this method, the component unit's financial data is reported as though the unit is party of the primary government.

Client: Any person or entity (other than the member's employer) that has engaged the member or the member's firm to provide professional services or a person or entity for which professional services or performed.

Components of internal control: Five interrelated components, including (1) control environment, (2) risk assessment, (3) information and communication, (4) monitoring, and (5) control activities.

Component units: When determining a *governmental financial reporting entity*, these are legally separate (1) organizations for which the elected officials of the primary government are financial accountable and (2) other organizations that must be included to keep the financial statements from being misleading because of the nature and significance of their relationship with the primary government.

Control: The direct or indirect ability to determine the direction of an organization's management and policies.

Control objectives: They state the purpose of a control (or controls) in relation to risks and "what could go wrong." They related to both entity-level controls and controls at the account balance, transaction class, disclosure, and program level.

Control risk of noncompliance: The risk that noncompliance with a compliance requirement that could occur and that could be material, either individually or when aggregated with other instances of noncompliance, with not be prevented, or detected and corrected, on a timely basis by the entity's internal control over compliance.

Cluster of programs: A grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development (R&D), student financial aid (SFA), and other clusters.

Deficiency in internal control over compliance: The design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement on a timely basis.

Discrete presentation: A financial reporting method for *component units* that do not meet the criteria for *blending*. Data from the component units is presented in one or more separate columns to the right of the primary data columns. Additional information about major component units and nonmajor component units in the aggregate should be presented in either combining statements or in condensed financial statements in the notes.

Economic interest: This exists in relation to a nonprofit organization when a different organization (1) holds or uses significant resources to directly or indirectly produce income for or provide services to the other organization or (2) is responsible for the other organization's liabilities.

Federal award: *Federal financial assistance* that a nonfederal entity receives directly from a federal awarding agency or indirectly from a pass-through entity, the cost-reimbursement contract under the Federal Acquisition Regulations that a nonfederal entity receives directly from a federal awarding agency or indirectly from a pass-through entity, or the instrument (e.g., grant agreement) setting forth the terms and conditions.

Federal financial assistance: According to 2 CFR section 200.40, this is assistance that nonfederal entities receive or administer in the form of (1) grants, (2) cooperative agreements, (3) noncash contributions or donations of property (including donated surplus property), (4) direct appropriations, (5) food commodities, and (6) other financial assistance. According to 2 CFR part 200, subpart F, it also includes (1) loans, (2) loan guarantees, (3) interest subsidies, and (4) insurance.

Federal program: All *federal awards* which are assigned a single *Catalog of Federal Domestic Assistance* (CFDA) number; if no CFDA number is assigned, all federal awards from the same agency made for the same purpose must be considered one program; and awards defined as a *cluster of programs*.

Governmental financial reporting entity: The primary government (e.g., a state government, general purpose local government, or special purpose government) and its *component units*.

Independence in appearance: The absence of circumstances that would cause a reasonable and informed third party, having knowledge of the relevant information, to reasonably conclude that the integrity, objectivity, or professional skepticism of an audit organization or member of the audit team had been compromised.

Independence of mind: The state of mind that enables performing an audit without being affected by influences that compromise professional judgment, thereby allowing the auditor to act with integrity and to exercise objectivity and professional skepticism.

Integrity: Conducting work with an attitude that is objective, fact-based, nonpartisan, and nonideological with respect to audited entities and users of the auditors' reports.

Key controls: Controls that are most important in achieving particular control objectives (and principles) related to identified risks. Also, controls that the client believes are the most effective and reliable in operation to fully address a control objective.

Management's specialist: These are individuals or organizations that have expertise in a field other than accounting or auditing who are used by the entity to assist in preparing the financial statements.

Material weakness in internal control over compliance: A deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

Nonaudit service: Any service provided by an auditor that is not in the Statements on Auditing Standards (e.g., assisting with preparation of the financial statements or preparing cash-to-accrual conversions). Some nonaudit services, such as authorizing transactions, are prohibited by the Yellow Book.

Objectivity: *Independence of mind*, *independence in appearance*, maintaining an attitude of impartiality, having intellectual honesty, and having no conflicts of interest.

Other specialist: Individuals on the engagement team or other individuals or organizations with whom the auditor consults who possess expertise in a specialized area of accounting or auditing.

Personally identifiable information (PII): Information that can be used to distinguish or trace an individual's identity, either alone or when combined with other personal or identifying information that is linked or linkable to a specific individual, such as telephone books and public websites.

Program income: Gross income earned by a non-federal entity that is directly generated by a supported activity or earned as a result of the *federal award* during the period of performance [unless there is a requirement for disposition of program income after the end of the period of performance as provided in 2 CFR section 200.307(f)].

Programmatic investment: An investment that meets both the following criteria: (1) it's purpose is to further the charitable objectives of a nonprofit organization and (2) the production of income or the appreciation of the asset is not a significant purpose (that is, an investor seeking a market return would not enter into the investment).

Public interest: The collective well-being of the community of people and entities that auditors serve.

Recipient: A nonfederal entity that receives federal awards directly from a federal awarding agency to carry out an activity under a federal program.

Request for proposal (RFP): A document used when entities that expend specified amounts of federal awards select an auditor under the procurement standards of the Uniform Guidance. When an RFP is used for audit services, it should (1) clearly describe the objectives and scope of the audit and (2) request a copy of the audit firm's peer review report. It may also include other information, such as the identification of reports and any other services sought.

Safeguards: Controls designed to eliminate *threats to independence* or reduce them to an acceptable level.

Significant deficiency in internal control over compliance: A deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Single audit: A type of audit that applies to nonfederal entities (primarily governmental units and nonprofit organizations) that expend $750,000 or more in a year in federal awards.

Stub period: The period of time between the end of the fiscal year and the beginning of the program year.

Subrecipient: Nonfederal entities that receive a subaward from a pass-through entity to carry out part of a federal program.

Threats to independence: Circumstances or activities that could, but do not necessarily, impair independence (e.g., self-interest, self-review, and bias).

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COMPANION TO PPC'S GUIDE TO SINGLE AUDITS

COURSE 3

PLANNING AND SAMPLING FOR SINGLE AUDITS (GSATG173)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course examines elements of the single audit process. Lesson 1 explains how to plan for a single audit engagement. Lesson 2 describes single audit sampling procedures.

PUBLICATION/REVISION DATE: September 2017

RECOMMENDED FOR: Users of *PPC's Guide to Single Audits*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of governmental auditing

CPE CREDIT: 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

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 **September 30, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Planning the Single Audit

Completion of this lesson will enable you to:

- Identify auditing and reporting considerations for single audits, the responsibilities of the cognizant or oversight agencies, and how to determine major federal award programs.
- Recognize state and local compliance requirements, appropriate risk assessment and planning procedures, and how to obtain an understanding of the entity and its environment in a single audit engagement.
- Determine how to make single audit planning decisions and judgments, necessary fraud considerations, audit program and documentation requirements, and which parts of a single audit may be performed by other auditors.

Lesson 2—Single Audit Sampling

Completion of this lesson will enable you to:

- Identify the requirements that apply to all Single Audit samples and guidelines for performing tests of controls over compliance.
- Determine how to perform and plan the extent of substantive tests of compliance.

TO COMPLETE THIS LEARNING PROCESS:

Submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
- Fax to: **(888) 286-9070**
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GSATG173 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) 431-9025 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.

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 federal award programs, identifying direct and material 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:

- Identify auditing and reporting considerations for single audits, the responsibilities of the cognizant or oversight agencies, and how to determine major federal award programs.
- Recognize state and local compliance requirements, appropriate risk assessment and planning procedures, and how to obtain an understanding of the entity and its environment in a single audit engagement.
- Determine how to make single audit planning decisions and judgments, necessary fraud considerations, audit program and documentation requirements, and which parts of a single audit may be performed by other auditors.

Authoritative Literature

The authoritative pronouncements that are relevant to a single audit engagement include both general pronouncements that are relevant to all audits of financial statements and pronouncements that are specific to entities expending federal awards. The authoritative pronouncements that establish requirements or that provide suggestions that most directly affect planning activities discussed in this lesson are as follows:

- AU-C 230, *Audit Documentation*.
- AU-C 240, *Consideration of Fraud in a Financial Statement Audit*.
- AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.
- AU-C 300, *Planning An Audit*.
- AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.
- AU-C 320, *Materiality in Planning and Performing an Audit*.
- AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.
- AU-C 500, *Audit Evidence*.

- AU-C 520, *Analytical Procedures*.
- AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.
- AU-C 610, *Using the Work of Internal Auditors*.
- AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*.
- AU-C 935, *Compliance Audits*.
- Title 2, U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). (The most current version of 2 CFR part 200 is in the Electronic Code of Federal Regulations (eCFR) at **www.ecfr.gov**/**cgi-bin**/**text-idx?tpl**=/**ecfrbrowse**/**Title02**/**2cfr200_main_02.tpl**.)
- *OMB Compliance Supplement*.
- AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide).
- GAO *Government Auditing Standards*, *2011 Revision* (Yellow Book). (A link to the Yellow Book is included in *PPC's Government Documents Library* at Gov. Doc. No. 2.)

This lesson focuses on the considerations that are relevant to the application of these pronouncements to the planning of a single audit.

Uniform Guidance. OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) is located in 2 CFR part 200. Its audit requirements are located in 2 CFR part 200, subpart F (2 CFR sections 200.500-.521). The most current version of 2 CFR part 200 is in the Electronic Code of Federal Regulations (eCFR) at **www.ecfr.gov**/**cgi-bin**/**text-idx?tpl**=/**ecfrbrowse**/**Title02**/**2cfr200_main_02.tpl**.

The auditor may need to test awards that are subject to two different sets of administrative requirements and cost principles. Award recipients have to implement new administrative requirements and cost principles for all new federal awards made on or after December 26, 2014, and for funding increments (additional funding on existing awards) with modified terms and conditions that are awarded on or after that date. Previous awards, including funding increments without modified terms and conditions, are subject to the previous administrative requirements and cost principles.

2017 Compliance Supplement. The 2017 Compliance Supplement, which is located in 2 CFR part 200, appendix XI, is effective for audits of fiscal years beginning after June 30, 2016. It provides guidance on awards that are subject to the administrative requirements and cost principles in the Uniform Guidance and those that are subject to the previous administrative requirements and cost principles. Part 3 of the 2017 Compliance Supplement explains that during the period covered by the Compliance Settlement some recipients will still have some federal awards that are subject to the administrative requirements and cost principles in the previous OMB circulars and some that are subject to those in the Uniform Guidance. Part 3 is divided into two separate sections that apply depending on which requirements are applicable to the award. Part 3.1 applies to awards made prior to December 26, 2014, including funding increments without modified terms and conditions awarded on or after that date. Part 3.2 applies to new awards made on or after December 26, 2014, and to funding increments with modified terms and conditions awarded on or after that date. If a major program includes expenditures from awards subject to pre-Uniform Guidance requirements and also from awards subject to the Uniform Guidance requirements, the auditor would use both Part 3.1 and Part 3.2, as applicable, to perform compliance testing. It is critically important for auditors to use the portion(s) of the Compliance Supplement that apply to the award being audited.

Objectives of Audit Planning

Planning an audit, according to AU-C 300.02, involves establishing the overall strategy for the engagement and developing an audit plan. 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, timing, and direction. 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). Audit strategy is discussed further later in this lesson.

Obtaining an understanding of the entity and its environment, including its internal control, is an essential part of planning the audit. An effectively planned audit is responsive to the assessment of the risks of material misstatement/noncompliance based on the auditors' understanding of the entity and its environment, including its internal control. The objective of the auditor, according to AU-C 315.03, is to identify and assess the risks of material misstatement (either due to fraud or error) at both the financial statement and relevant assertion levels by understanding the entity and its environment (including its internal control) to provide a basis for the design and implementation of responses to such risks.

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 GAS/SA Audit Guide, Paragraph 3.08, explains that the nature and extent of audit planning varies with the size and complexity of the entity, the previous experience that key members of the engagement team have with the entity, and changes in circumstances that occur during the audit. 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. It is useful to classify the audit requirements related to planning in the following categories:

- Procedures performed.
- Understanding obtained.
- Decisions and judgments made.

Risk assessment and other planning procedures, obtaining an understanding of the entity and its environment, and planning decisions and judgments are discussed later in this lesson.

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 performs all of these procedures when planning the audit.

The auditor's consideration of fraud in accordance with AU-C 240, *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 6.41 of the GAS/SA Audit Guide, "the auditor should specifically assess the risks of material noncompliance with a major program's compliance requirements occurring due to fraud," and should consider that assessment when designing audit procedures. Paragraph 6.42 of the GAS/SA Audit Guide explains that in a single audit, the assessment of fraud risk relates to fraudulent acts that might result in material noncompliance with a major program's compliance requirements or in the misappropriation of federal funds. An in-depth discussion of fraud considerations is provided later in this lesson.

Understanding Obtained. In a financial statement audit, the auditor performs risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels. Components of that understanding

are discussed later in this lesson. AU-C 935.15 extends the requirement to perform risk assessment procedures to a compliance audit. It states that the auditor should perform risk assessment procedures to obtain an understanding of applicable compliance requirements and internal control over compliance with the applicable compliance requirements.

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 6.25 of the GAS/SA Audit Guide explains that, in a single audit, the auditor considers audit risk of noncompliance and materiality together for each major program being audited 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 federal statutes, regulations, and the terms and conditions of federal awards. The auditor's objectives in a single audit include (a) performing an audit of the financial statements and reporting on the supplementary schedule of expenditures of federal awards and (b) performing a compliance audit of federal awards.

When performing a single audit in accordance with the Uniform Guidance, the auditor is required to determine whether:

- The entity's financial statements are presented fairly in all material respects in accordance with generally accepted accounting principles and the schedule of expenditures of federal awards is stated fairly in all material respects in relation to the entity's financial statements as a whole.

- The entity has internal controls that provide reasonable assurance that the entity is managing its federal awards in compliance with the applicable federal statutes, regulations, and the terms and conditions of federal awards. As part of performing a compliance audit, the auditor is required to perform procedures to obtain an understanding of the internal control over compliance for major programs, plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program, and test the controls as planned (unless the controls are likely to be ineffective).

- The entity has complied with federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on each major federal program.

Reports Required in a Single Audit

The Uniform Guidance 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* (the Yellow Book)

a. Opinion (or disclaimer of opinion) on whether the financial statements are presented fairly in all material respects in accordance with GAAP.

b. Report on internal control over financial reporting.

c. Report on compliance with laws, regulations, contracts, and grant agreements.

Reports Related to Federal Award Programs Required by the Uniform Guidance in Addition to Items a. through c.

d. An *in relation to opinion* (or disclaimer of opinion) on the schedule of expenditures of federal awards.

e. Report on internal control over compliance.

f. An *opinion* (or disclaimer of opinion) as to whether the auditee complied with federal statutes, regulations, and the terms and conditions of federal awards that could have a direct and material effect on each major program.

g. Schedule of findings and questioned costs that includes (1) a summary of the auditor's results, (2) findings relating to the financial statements that *Government Auditing Standards* requires to be reported, and (3) findings and questioned costs for federal awards.

The Yellow Book and the Uniform Guidance 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 the Uniform Guidance into a single report.

AU-C 725 Planning Considerations

2 CFR section 200.515(a) requires the auditor to give an opinion (or disclaimer of opinion) "as to whether the schedule of expenditures of Federal awards is fairly stated in all material respects in relation to the financial statements as a whole." This requirement is referring to an *in relation to opinion* on supplementary information. According to AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, the supplementary information is not a required part of the basic financial statements and is not considered necessary for the financial statements to be fairly presented. The auditor's opinion on the information concerns whether it is fairly stated in all material respects in relation to the financial statements as a whole. Conditions that should be met and procedures to apply to supplementary information in order to express such an opinion are discussed in *PPC's Guide to Single Audits*.

Other Planning Considerations

In planning a single audit, the auditor considers both the requirements of an audit of financial statements and the requirements of a compliance audit. The auditor must 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 must report, as a current year audit finding, when the auditee materially misrepresents the status of any prior audit finding. The auditor must 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 must 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/SA Audit Guide, Paragraph 10.69, explains that the procedures might include:

- 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.

Transition Considerations in a Uniform Guidance Audit. The GAS/SA Audit Guide provides the following considerations for planning a Uniform Guidance audit:

- The administrative requirements and cost principles in the Uniform Guidance were required to be implemented by nonfederal entities beginning December 26, 2014, for all new federal awards and funding increments with modified award terms and conditions that were awarded on or after that date. For funding increments, the award terms and conditions will usually identify whether the funding increment is subject to the requirements in the Uniform Guidance or to the original terms and conditions of the federal award (i.e., the pre-Uniform Guidance administrative requirements and cost principles). (GAS/SA Audit Guide, Paragraph 5.50)

- Some nonfederal entities will continue to make expenditures from older awards that are still subject to the pre-Uniform Guidance administrative requirements and cost principles will continue for several years until they are fully expended. Therefore, the auditor should determine the applicable criteria to use when performing the compliance audit (that is, whether an award is subject to pre-Uniform Guidance administrative requirements and cost principles or the post-Uniform Guidance administrative requirements and cost principles). Federal awarding documents and subawards will be important tools for making this determination. They may also be useful in determining whether the criteria used by the auditee are appropriate. (GAS/SA Audit Guide, Paragraphs 6.75–.76)

- When performing procedures to obtain an understanding of internal control over compliance, the auditor should also consider whether the auditee changed or updated its internal controls over compliance to a greater extent than usual because it implemented the Uniform Guidance. (GAS/SA Audit Guide, Paragraph 6.77)

- A nonfederal entity may delay implementation of the Uniform Guidance procurement standards for three full fiscal years beginning with its fiscal year that begins on or after December 26, 2014. If this election is made, the entity must document whether it is in compliance with the old or new procurement standards and must meet the documented standard. It is important for the auditor to know whether the entity has elected to delay implementation of the Uniform Guidance procurement standards due to its potential effect on compliance testing. (GAS/SA Audit Guide, Paragraph 5.52)

- Some federal agencies received OMB approval to make exceptions to certain requirements in the Uniform Guidance. For example, an agency might disallow a particular type of cost that would otherwise be permitted under the Uniform Guidance cost principles. Some of the exceptions could affect the program's compliance requirements, and accordingly, the compliance audit. (GAS/SA Audit Guide, Paragraph 5.53)

Note: The OMB removed the listing of agency exceptions from the 2017 Compliance Supplement because it was outdated. The list approved by OMB on December 19, 2014, is available at **https://cfo.gov/wp-content/uploads/2014/12/Agency-Exceptions.pdf**. According to Appendix VII of the 2017 Compliance Supplement, for programs included in the Compliance Supplement, auditors should review the program supplement and, as necessary, agency regulations adopting/implementing the OMB Uniform Guidance in 2 CFR part 200 to determine if there is any exception related to the compliance requirements that apply to the program. For programs not included in the Compliance Supplement that are audited using Part 7, auditors should review agency regulations adopting/implementing 2 CFR part 200 to determine if an exception applies to the program.

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

Cognizant Agency for Audit

Nonfederal entities expending more than $50 million a year in federal awards must have a designated cognizant agency for audit. The designated cognizant agency for audit must be the federal awarding agency that provides the predominant amount of direct funding to the entity unless OMB designates a specific cognizant agency for audit. 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 2014, 2019, and every fifth

year thereafter. For example, audit cognizance for periods ended or ending in 2016–2020 would be determined based on federal awards expended in 2014. This means that cognizance will remain with the same federal agency for at least five years. The Uniform Guidance allows the federal awarding agency with cognizance for an auditee to reassign cognizance to another federal awarding agency if it both provides substantial funding and agrees to be the cognizant agency for audit. Within 30 calendar days after any reassignment, both the old and the new cognizant agency for audit will notify the auditee, federal audit clearinghouse, and, if known, the auditor of the reassignment.

The Uniform Guidance differentiates between a "cognizant agency for audit" and a "cognizant agency for indirect costs." The cognizant agency for indirect costs is the federal agency responsible for reviewing, negotiating, and approving cost allocation plans or indirect cost proposals on behalf of all federal agencies and is not necessarily the same as the cognizant agency for audit. Usually, the cognizant agency for indirect costs is the federal agency with the largest dollar value of federal awards with a nonfederal entity.

Responsibilities of the Cognizant Agency for Audit. Section 200.513(a) of the Uniform Guidance and Paragraph 5.43 of the GAS/SA Audit Guide list the following responsibilities of a cognizant agency for audit:

- Provide technical audit advice and liaison assistance to auditees and auditors.

- Obtain or conduct quality control reviews of selected audits made by nonfederal auditors, and provide the results to other interested organizations.

- Cooperate and provide support to the federal agency designated by OMB to lead a government-wide project to determine the quality of single audits by providing a statistically reliable estimate of the extent that single audits conform to applicable requirements, standards, and procedures; and to make recommendations to address noted audit quality issues, including recommendations for any changes to applicable requirements, standards and procedures indicated by the results of the project.

- Promptly inform other affected federal agencies and appropriate federal law enforcement officials of any direct reporting by the auditee or its auditor required by *Government Auditing Standards* or statutes and regulations.

- Advise the community of independent auditors of any noteworthy or important factual trends related to the quality of audits stemming from quality control reviews. Significant problems or quality issues consistently identified through quality control reviews must be referred to appropriate state licensing agencies and professional bodies.

- Advise the auditor, federal awarding agencies, 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 must work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit must 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 must 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 the Uniform Guidance, so that the additional audits or reviews build upon audits performed in accordance with the Uniform Guidance.

- Coordinate a management decision for cross-cutting audit findings that affect the federal programs of more than one agency when requested by any federal awarding agency whose awards are included in the audit finding.

- Coordinate the audit work and reporting responsibilities among auditors to achieve the most cost-effective audit.

- Advise auditees regarding how to handle changes in fiscal years.

It is important to note that the cognizant agency for audit is not required to approve the recipient's selection of an independent auditor. When selecting an independent auditor, recipients must, however, follow the procurement standards in Uniform Guidance sections 200.317 through 200.326 or those in the Federal Acquisition Regulation (48 CFR part 42), as applicable. Section 200.509 of the Uniform Guidance requires recipients to make positive efforts to use small businesses, minority-owned firms, and women's business enterprises in procuring audit services.

Oversight Agency for Audit

As noted above, the OMB has assigned cognizant agencies for audit for larger governmental and nonprofit entities. Section 200.513(b) of the Uniform Guidance explains 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 non-Federal entity not assigned a cognizant agency for audit. When there is no direct funding, the Federal awarding agency which is the predominant source of pass-through funding must assume the oversight responsibilities.

Section 200.73 of the Uniform Guidance 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 200.513(b) of the Uniform Guidance and Paragraph 5.45 of the GAS/SA 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 above, normally performed by a cognizant agency for audit.

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

The Uniform Guidance allows for reassignment of an oversight agency for audit. 2 CFR section 200.513(b) states that—

> A Federal agency with oversight for an auditee may reassign oversight to another Federal agency that agrees to be the oversight agency for audit. Within 30 calendar days after any reassignment, both the old and the new oversight agency for audit must provide notice of the change to the FAC, the auditee, and, if known, the auditor.

Cognizant and Oversight Agencies for Audit—Identification Issues

Identification of cognizant and oversight agencies for audit and reporting such information on the data collection form may present issues such as (a) whether the auditee should have a cognizant or an oversight agency for audit or (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. As indicated at the beginning of this section, 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 Pass-through Funding. As discussed earlier, if the OMB has not designated a specific cognizant agency for audit, the entity's cognizant agency for audit is the federal agency that provides the predominant amount of direct funding. 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 pass-through or total funding) from the agency. Direct funding has precedence over any amount of pass-through 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 designation by OMB). If the auditee does not receive any direct funding, the federal agency that is the predominant source of pass-through 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.S. Department of Education		
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.S. Department of Agriculture		
Food Donation Program	10.550	150,000
Total		$ 3,350,000

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 that is the predominant source of pass-through 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 ought to determine, through discussion with the client and review of relevant correspondence, whether a cognizant agency for audit has been assigned. [As discussed previously, cognizant agencies for audit have been instructed to contact auditees (and their auditors, if known) within 30 calendar 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 (Uniform Guidance audit). Note that an auditee may only have one federal agency designated as its cognizant or oversight agency for audit for purposes of performing a Uniform Guidance audit. It is important to 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 6.70 of the GAS/SA Audit Guide notes that auditors may communicate with the cognizant or oversight agency for audit to aid in planning the audit. If a planning meeting is held, the auditor might consider discussing the following matters:

- The scope of the compliance testing of federal programs.
- The intended use of the Compliance Supplement.
- Identification of federal awards, 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 audit findings and questioned costs.
- Federal agency or pass-through entity management decisions on prior audit findings.
- Compliance requirements and any changes to those requirements.

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 ought to also consider whether any communication is necessary with other federal awarding agencies, pass-through entities, state auditors, or state awarding agencies.

FAILURE TO FOLLOW *GOVERNMENT AUDITING STANDARDS*

The Uniform Guidance requires that an audit be performed by an independent auditor in accordance with *Government Auditing Standards*. *Government Auditing Standards* place on the auditor additional reporting requirements and additional requirements related to independence, continuing professional education, and quality control. In addition, the auditor is required to comply with additional documentation requirements.

When performing a single audit, the auditor should be familiar with AICPA Ethics Interpretation 1.400.055, which states that a member who accepts an engagement to audit government grants, governmental units, or other recipients of government monies when such audits are to be performed in compliance with government audit standards, guides, procedures, statutes, rules, and regulations, that are in addition to GAAS, is obligated to follow such requirements. Failure to follow such standards would be an act discreditable to the profession unless the report discloses the failure to follow such requirements and the reasons.

The auditor needs to also be familiar with Paragraph 2.24 of the Yellow Book, which requires auditors to modify their report if they have not followed all applicable unconditional and presumptively mandatory *Government Auditing Standards* requirements. It requires auditors to disclose in their report (a) the requirement(s) not followed, (b) the reasons for not following the requirement(s), and (c) how not following the requirement(s) affected, or could have affected, the audit and the assurance provided. Auditors also have to assess the significance of the noncompliance to the audit objectives and document that assessment and their reasons for not complying with the requirement.

Other requirements of *Government Auditing Standards* are discussed throughout *PPC's Guide to Single Audits*. When planning an audit in accordance with the Uniform Guidance, the auditor needs to be certain that he or she will be able to comply with these requirements.

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 the Uniform Guidance focus on *major* federal award programs in determining the extent of tests of controls and whether additional tests of compliance with federal statutes, regulations, and the terms and conditions of federal awards are necessary. The Uniform Guidance defines a major program in terms of federal awards expended during a fiscal year. It is important to note that under the Uniform Guidance, both the threshold for requiring a single audit and the determination of a major program are based on federal awards *expended*. The Uniform Guidance provides nonfederal 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.

Program Identification—Programs and Clusters of Programs

It is important to 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 has to be determined before applying the risk-based approach discussed later in this lesson. All grants with the same *Catalog of Federal Domestic Assistance* (CFDA) number are combined as a single program even if they are reported separately. For awards not assigned a CFDA number, combine all awards provided by the same agency for the same purpose. A cluster of programs is also considered a federal program.

GAQC Alert about Inaccurate Information on CFDA Website. In GAQC Alert No. 119, *Problem with CFDA.gov Leads to Inaccurate Notation of Single Audit Applicability*, the AICPA notified auditors that information on the CFDA website regarding whether a single audit is required for a specific program may be incorrect. The AICPA recommends that if **www.CFDA.gov** indicates a program does not have a single audit requirement, the auditor should check the Compliance Supplement. If the program is included in the Compliance Supplement, the auditor should assume it is subject to a single audit. If the program is not listed in the Supplement, the auditor should contact the single audit coordinator for the agency under which the program falls to obtain a definitive answer about whether single audit requirements apply.

Pass-through Entity Responsibilities. 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 must attempt to identify the number by contacting the pass-through entity or reviewing the CFDA.

Cluster of Programs. The Uniform Guidance 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 are:

a. Research and development (R&D).

b. Student financial aid (SFA).

c. Other clusters, as defined by OMB in the Compliance Supplement or as designated by the state.

A cluster of programs must 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. Program-specific audits are discussed in *PPC's Guide to Single Audits*. 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 do not meet the criteria for a major program will more likely be selected as major programs under the risk-based approach.

2 CFR section 200.17 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," 2 CFR section 200.17 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 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 the Uniform Guidance. 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 are evaluated together under the four-step risk-based approach discussed below. Thus, if selected as a major program, all individual programs that the entity has within the cluster are 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/SA Audit Guide notes that, while the Uniform Guidance 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. The GAS/SA Audit Guide, Paragraph 8.03, explains that, for purposes of determining major programs, federal programs with the same CFDA number are considered to be one program. In addition, a cluster of programs must be considered as one program.

Section 200.518(a) of the Uniform Guidance 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 material noncompliance occurring instead of focusing on programs with large dollar expenditures. The approach includes consideration of:

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

Section 200.519(a) of the Uniform Guidance states "the auditor's determination [of federal program risk] should be based on an overall evaluation of the risk of noncompliance occurring that could be material to the Federal program." Auditors must consider criteria such as that in Exhibit 1-1 to identify risk in federal programs. Auditors may also want to consult with entity management and the federal awarding agency concerning particular programs.

Exhibit 1-1

Federal Program Risk Criteria

Current and Prior Audit Experience:

- Weaknesses in internal control over compliance for federal programs.
- Expectations about management's adherence to federal statutes, regulations, and the terms and conditions of federal awards.
- The competence and experience of personnel administering the programs.
- Whether the program is administered under multiple or single internal control structures and whether any weaknesses in internal control are systemwide or confined to one structure.

- Whether the program has subrecipients and the strength of the subrecipient monitoring system.
- Prior audit findings, including whether the auditee has taken appropriate corrective action to address findings and recommendations that could have a significant impact on a federal program.
- Whether a program has recently been audited as a major program.

Oversight by Federal Agencies and Pass-through Entities:

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

Inherent Risk of the Program (applicable only to Type B programs):

- The nature of the program, including its complexity and extent to which the program contracts for goods and services (e.g., inherent risk of noncompliance 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. 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, statutes, regulations, or the terms and conditions of federal awards. (Significant changes may increase risk.)
- The size of the program (e.g., programs with larger expenditures).

* * *

The Uniform Guidance describes a four-step process to determine major programs. In addition, as part of transitioning to the Uniform Guidance requirements, Appendix VII of the 2017 Compliance Supplement provides an option to audit more programs as major programs than the number determined in the four-step process. See the discussion later in this lesson. The auditor must adequately document the risk evaluation process and the selection of major programs for testing. If major programs are determined and documented in accordance with 2 CFR part 200, subpart F, 2 CFR section 200.518(h) states "the auditor's judgment in applying the risk-based approach to determine major programs must be presumed correct." Federal agencies and pass-through entities may only challenge the auditor's judgment "for clearly improper use of the requirements" in the Uniform Guidance. Practice aids such as the ones in *PPC's Guide to Single Audits* can be used to assist auditors in determining major programs using the risk-based approach and providing the necessary documentation of the process. Proper use of practice aids will likely satisfy OMB and granting agency requirements. A summary of the four steps follows.

Step 1—Identify Type A and Type B Programs

Under the Uniform Guidance, 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 based on Section 200.518(b) of the Uniform Guidance.

Exhibit 1-2

Determining Type A Programs

If Total Federal Awards Expended Are:	A "Type A" Program Is Any Program with Federal Awards Expended That Exceed:
$750,000 to $25 million	$750,000
$25,000,001 to $100 million	3% (.03) of total federal awards expended
$100,000,001 to $1 billion	$3 million
$1,000,000,001 to $10 billion	.3% (.003) of total federal awards expended
$10,000,000,001 to $20 billion	$30 million
Above $20 billion	.15% (.0015) of total federal awards expended

* * *

Any programs that do not meet the Type A criteria specified in Exhibit 1-2 must be labeled Type B programs.

Treatment of a Loan or Loan Guarantee Program. If a governmental unit or nonprofit organization operates a federal loan or loan guarantee program, the value of large loan and loan guarantee programs must be excluded from the base (total federal awards) for applying the Type A threshold formula (see Exhibit 1-2) if it is considered a large loan program. Section 200.518(b)(3) of the Uniform Guidance states:

> The inclusion of large loan and loan guarantees (loans) must not result in the exclusion of other programs as Type A programs. When a Federal program providing loans exceeds four times the largest non-loan program it is considered a large loan program, and the auditor must consider this Federal program as a Type A program and exclude its values in determining other Type A programs. This recalculation of the Type A program is performed after removing the total of all large loan programs. For the purposes of this paragraph a program is only considered to be a Federal program providing loans if the value of Federal awards expended for loans within the program comprises fifty percent or more of the total Federal awards expended for the program. A cluster of programs is treated as one program and the value of Federal awards expended under a loan program is determined as described in §200.502 Basis for determining Federal awards expended.

Paragraphs 8.07–.08 and Table 8-2 of the GAS/SA Audit Guide illustrate the computation.

For making this calculation, a program is considered to be a federal program providing loans if the value of federal awards expended for loans within the program is at least 50 percent of the total federal awards for the program (with a cluster of programs treated as a single program). If the federal program providing loans exceeds four times the largest non-loan program, (a) it is considered a *large loan program* and (b) it is a Type A program and its value will be excluded in determining the Type A threshold.

Step 2—Identify Low-risk Type A Programs

Section 200.518(c) of the Uniform Guidance 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).

- In the most recent audit period, the program did not have any of the following:
  - Internal control deficiencies that were identified as material weaknesses in the auditor's report on internal control for major programs.
  - A modified opinion on the program in the auditor's report on major programs.
  - Known or likely questioned costs that exceed 5% of the total federal awards expended for the program.

The Uniform Guidance changed the criteria for determining risk of Type A programs. The GAS/SA Audit Guide, Paragraph 8.10, explains that the auditor is no longer permitted to use judgment based on a Type A program's inherent risk. The only criteria the auditor may consider are the following:

- Oversight exercised by federal agencies and pass-through entities as described in 2 CFR section 200.519(c) (for example, results of recent monitoring or other reviews or indication in the Compliance Supplement that a federal agency has identified a federal program as higher risk).
- The results of audit follow-up.
- Any changes in personnel or systems affecting the program.

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 requirements in 31 U.S.C. 3515, *Financial statements of agencies*. The federal agency is responsible for notifying entities receiving awards under such programs (and their auditors, if known) at least 180 calendar days before the end of the fiscal year being audited.

Addition of a New Program to an "Other Cluster." Appendix VII of the 2017 Compliance Supplement added guidance on the effect of a newly added program to an existing "other cluster". In order for an "other cluster" to be considered a low-risk Type A program, 2 CFR section 200.518(c)(1) requires it to have been audited as a major program in at least one of the two most recent audit periods. In years where the Compliance Supplement adds a new program to an "other cluster" listed in Part 5, additional consideration is required to determine whether the other cluster meets the criteria to be considered a low-risk Type A program. During that year, the "other cluster" cannot qualify as having been audited as a major program in one of the two most recent audit periods unless the auditee's current-year expenditures for the newly added program were less than or equal to twenty-five percent (0.25) of the Type A threshold, or all of the programs included in the resulting other cluster met the 2-year lookback criterion. The additional criteria in 2 CFR section 200.518(c) must also be evaluated by the auditor to determine if the other cluster can be considered a low-risk Type A program in the current year. In addition, in years after the Compliance Supplement adds a program to an "other cluster," such addition in a prior year does not require additional consideration for the 2-year lookback criterion. (Note: The only existing "other cluster" with a program added in the 2017 Compliance Supplement is the Highway Planning and Construction Cluster. The added program is CFDA 20.224, Federal Lands Access Program.) Auditors should note this new guidance does not apply to the SFA or R&D Clusters.

SFA Cluster Annual Audit Policy Memoranda and GAQC Alert. On August 5, 2016, the Department of Education (ED) issued a memorandum, *Applicability of Single Audit Act Regulations to the Title IV Student Aid Programs,* which announced ED's policy position that Title IV student assistance programs [including the Student Financial Aid (SFA) cluster] are to be audited annually under the Higher Education Act (HEA) regardless of whether those programs meet the guidelines under the Uniform Guidance to be audited as a major program. The AICPA Government Audit Quality Center (GAQC) notes in GAQC Alert No. 312, issued August 22, 2016, that auditors most frequently will find these Title IV programs when auditing the SFA cluster (included in Part V of the OMB Compliance Supplement). The August 2016 announcement and the GAQC Alert instruct auditees to contact their ED School Participation Division if an auditee expends funds under the SFA Cluster and it is a Type A program that will not be audited as a major program either because it is considered a low-risk program under the Uniform Guidance or it is not needed to meet the percentage of coverage requirements.

After being contacted by the auditee, the ED School Participation Division staff will review prior years' audits and other information to ensure they are not aware on anything that would preclude treating the SFA cluster as a

low-risk Type A program. A waiver may be granted as the result of this process. An April 2017 memorandum from ED extends the previous guidance from the 2016 announcement to include audits of the 2017 fiscal year. Auditees should be familiar with GAQC Alert No. 312 (**https://www.aicpa.org/InterestAreas/GovernmentalAuditQuality/NewsAndPublications/GA QCALERT/2016/Pages/GAQCAlertNo312.aspx**). The ED April 2017 memorandum that links to previous memorandum and also addresses fiscal year 2017 single audits is available at **https://ifap.ed.gov/eannouncements/042817AuditsPerformedUnderUniformGuid4FYEndingin2017.html**. Auditors and auditees need to carefully follow developments in this area and consult with the relevant ED School Participation Division staff as appropriate.

Auditors should note that ED did not follow the formal process in 2 CFR section 200.518(c)(2) to obtain OMB approval and notify auditors and auditees that the SFA cluster could not be considered low-risk. Instead, ED cites the HEA, among other things, as the authority to require annual audits. Based on discussions with AICPA staff, its is believed the guidance in 2 CFR section 200.503(e) will likely not apply to the SFA cluster issue since ED is citing other authority to require annual audits (and would not be paying the incremental costs).

Step 3—Identify High-risk Type B Programs

Similar to Step 2, auditors must use professional judgment and the federal program risk criteria discussed previously to identify high-risk Type B programs. However, the auditor is not required to identify more high-risk Type B programs than at least one-fourth the number of Type A programs identified as low-risk under Step 2. Section 200.518(d) of the Uniform Guidance states:

> Except for known material weakness in internal control or compliance problems . . . a single criteria in risk would seldom cause a Type B program to be considered high-risk. When identifying which Type B programs to risk assess, the auditor is encouraged to use an approach which provides an opportunity for different high-risk Type B programs to be audited as major over a period of time.

Caution about Approach to Identifying High-risk Type B Programs. An Emphasis Point at Paragraph 8.16 of the GAS/SA Audit Guide cautions auditors about the approach they use to identify high-risk Type B programs. Because the Uniform Guidance requires all Type B programs *identified* as high-risk to be audited as major programs, auditors should avoid using an approach that may result in identifying more high-risk Type B programs than would otherwise be required (which is, at least one-fourth the number of low-risk Type A programs). If the auditor performs risk assessments on more Type B programs than would be required under the Uniform Guidance, and identifies more high-risk Type B programs than required, all of the additional high-risk type B programs *must* be audited as major programs. Consideration of the approach to identifying high-risk Type B programs should occur while planning the single audit engagement.

Small Program Exception. 2 CFR section 200.518(d)(2) permits the auditor to exclude relatively small federal programs from the risk analysis process. The auditor is only required to perform risk assessments on Type B programs that exceed 25% (0.25) of the Type A threshold determined in Step 1.

Step 4—Determine Major Programs

Major programs are determined using the results of the risk analysis performed in Steps 2 and 3. 2 CFR section 200.518(e) states that at a minimum, the following programs must be audited as major programs:

- *Non Low-risk (i.e., High-risk) Type A Programs.* 2 CFR section 200.518(e)(1) requires all Type A programs, except those identified as low-risk, to be considered major programs.
- *High-risk Type B Programs.* 2 CFR section 200.518(e)(2) requires all Type B programs identified as high risk to be considered major programs.
- *Additional Programs, as Necessary, to Comply with the Percentage of Coverage Rule.* The percentage of coverage rule is discussed below.

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 2 CFR section 200.518(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. In addition, as part of transitioning to the Uniform Guidance requirements, Appendix VII of the 2016 Compliance Supplement provides an option to audit more low-risk Type A programs as major programs than the number determined in the four-step process.

Selecting Type B Programs. Type B programs are only audited as major programs if (a) they are identified as high risk or (b) they must be considered major programs to meet the percentage of coverage rule. When identifying which Type B programs to risk assess, 2 CFR section 200.518(d) encourages auditors to use an approach that provides an opportunity for different high-risk Type B programs to be audited as major programs over a period of time.

Compliance Supplement (Appendix VII) Option to Audit Additional Low-risk Type A Programs as Major Programs. Appendix VII of the 2017 Compliance Supplement explains that audit burden might be significantly increased in the third year after implementing the Uniform Guidance audit requirements (for example, audits of December 31, 2017 year-ends and years ending in 2018) because the criteria that can be considered in determining whether a Type A program is low-risk changed under the Uniform Guidance. The changes will likely result in more low-risk Type A programs being identified each year than the auditor would have identified under OMB Circular A-133. A significant increase in the number of low-risk Type A programs in the first and second year of implementing the Uniform Guidance audit requirements would result in a significant increase in the number of major programs in the third year. This is because low-risk Type A programs that were last audited when OMB Circular A-133 was effective would not have been audited as major programs in at least one of the two most recent audit periods.

Appendix VII of the 2017 Compliance Supplement provides a "smoothing" option that allows the auditor to audit some low-risk Type A programs as *additional major programs* in the first and second years of implementing the Uniform Guidance in order to ease audit burden in the third year when the programs would otherwise have to be audited as major programs. (However, a low-risk Type A program cannot be audited more than once in the first three years.) This option does not change the application of the four-step process discussed previously for determining major programs, including the selection of additional programs to meet percentage-of-coverage requirements. Rather, any low-risk Type A programs chosen by the auditor for early major program treatment would be *in addition to major programs required to be tested using the four-step approach*.

Appendix VII explains that smoothing the audit of low-risk Type A programs during the first three years of implementation would not result in additional costs overall, and the costs associated with auditing the low-risk Type A programs in advance would be allowable. In addition, this method would allow for a more balanced workload in the initial years of implementation and help ensure audit quality because it would enable a more consistent approach for budgeting and determining staffing resources.

Percentage of Coverage Rule and Low-risk Auditee Exception

Federal programs with aggregate federal awards expended that encompass at least 40% of total federal awards expended must be audited as major programs. However, this percentage can be reduced to 20% for entities that qualify as "low-risk auditees." Low-risk auditees are discussed later in this lesson. 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 auditor's knowledge of the programs.
- Whether the programs are included in the 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.

Paragraph 8.17 of the GAS/SA Audit Guide clarifies several issues relating to the percentage of coverage rule. Specifically, it indicates 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 may 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 40% to 20% for entities that qualify as low-risk auditees. For all auditees, auditors still select major programs as indicated in Step 4 discussed previously. 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:
>
> | Programs | Type | Risk Classification | Federal Expenditures |
> |---|---|---|---|
> | 1 | A | Low-risk | $ 3,225,000 |
> | 2 | A | Non low-risk (high-risk) | 1,200,000 |
> | 3 | A | Non low-risk (high-risk) | 1,100,000 |
> | 4 | A | Low-risk | 1,300,000 |
> | 5 | B | Low-risk | 475,000 |
> | 6 | B | High-risk | 460,000 |
> | 7 | B | Low-risk | 130,000 |
> | 8 | B | Low-risk | 110,000 |
> | | | | $ 8,000,000 |
>
> *Non low-risk auditee.* If the entity is not a low-risk auditee, at least 40% of total federal expenditures must be classified as major programs. Using the criteria in Step 4 discussed previously, the auditor would select programs 2, 3, and 6 as major programs, which provides 34.50% ($2,760,000/$8,000,000) coverage of total federal expenditures. As a result, the auditor would have to select one or more additional programs to meet the 40% threshold.
>
> *Low-risk auditee.* If the entity is a low-risk auditee, only 20% 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 34.50% ($2,760,000/$8,000,000) coverage of total federal expenditures. Considering the reduced coverage percentage (20%) 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 20% 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.

An Emphasis Point at Paragraph 8.17 of the GAS/SA Audit Guide highlights two major points:

- The percentage of coverage rule represents the *minimum* coverage to be achieved, and is calculated after the auditor makes an initial determination of the major programs to be audited. After the initial determination is made, the auditor then has to determine if additional programs are required to be selected for audit.

- The percentage of coverage calculation is based on *final* total federal expenditures in the schedule of expenditures of federal awards. If the auditor starts the audit before the final year-end expenditure amounts are available, both the Type A program threshold and the percentage of coverage dollar amounts should be checked after the final total federal expenditure amounts are known in order to make sure that the proper major programs have been selected and that the percentage of coverage rule 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. 2 CFR section 200.503(e) states that "such requests should be made at least 180 calendar days prior to the end of the fiscal year to be audited." The auditee should inform the federal awarding agency whether the program would otherwise be audited as a major program and, if not, the estimated incremental cost. The federal awarding agency must then confirm whether it wants the program audited as a major program. If the program is to be audited as a major program based upon this request, and the federal awarding agency agrees to pay the full incremental cost of auditing the program, the auditee must have the program audited as a major program.

Low-risk Auditees

Criteria for a Low-risk Auditee. To be eligible for a reduced threshold for testing (i.e., 20% of total federal awards expended tested as major programs instead of 40%), 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 2 CFR section 200.520, for each of the previous two audit periods:

- Single audits were performed on an annual basis in accordance with the Uniform Guidance, including submitting the data collection form and reporting package to the federal audit clearinghouse within the earlier of 30 calendar days after the auditor's report is received or nine months after the end of the audit period. (An entity that has biennial audits does not qualify as a low-risk auditee.)

- The auditor's opinion on whether the financial statements were prepared in accordance with GAAP, or a basis of accounting required by state law, and the auditor's in-relation-to opinion on the schedule of expenditures of federal awards were unmodified.

- No deficiencies in internal control were identified as material weaknesses under Yellow Book requirements.

- The auditor did not report substantial doubt about the entity's ability to continue as a going concern.

- None of the federal programs had audit findings from *any* of the following *in either of the preceding two audit periods in which they were classified as Type A programs:*

    - Internal control deficiencies that were identified as material weaknesses in the auditor's report on internal control over compliance for major programs.

    - A modified opinion on a major program in the auditor's report on major programs.

    - Known or likely questioned costs that exceeded 5% of the total federal awards expended for a Type A program during the audit period.

If the entity only had Type B programs (and no Type A programs) for each of the previous two audit periods, 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 four criteria.

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 discussed previously identify sufficient major programs to meet the higher 40% (versus 20% for low-risk auditees) percentage of coverage rule. However, 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 answers the question, "Did the auditee qualify as a low-risk auditee?" The only possible answers on the form are "Yes" or "No." As a result, it may be 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. Michele is determining materiality levels and assessing risks of material misstatement. Which of the three categories of the risk assessment process is she performing?

   a. Procedures performed.

   b. Decisions and judgments made.

   c. Understanding obtained.

   d. Reporting in a single audit.

2. The Hurst Independent School District expended $12 million in federal awards during the year. $10 million passed through the State Education Agency; the remainder came directly from the U.S. Department of Agriculture. Would the school district have a cognizant or oversight agency for their audit, and who would be the proper agency for the audit and reporting?

   a. The U.S. Department of Agriculture would be the oversight agency.

   b. The U.S. Department of Agriculture would be the cognizant agency.

   c. The State Education Agency would be the oversight agency.

   d. The State Education Agency would be the cognizant agency.

3. Bob is performing a single audit and must determine the major programs. According to the Uniform Guidance, what is the first step Bob should perform in identifying major programs?

   a. Identify low-risk Type A programs.

   b. Identify high-risk Type B programs.

   c. Identify Type A and Type B programs.

   d. Determine major programs.

4. In order for an entity to be considered a low-risk auditee, it must meet certain criteria for each of the previous two audit periods. Which of the items below is one of the criteria specified in 2 CFR section 200.520?

   a. Less than five deficiencies in internal control were identified under Yellow Book requirements as material weaknesses.

   b. Single audits were performed biennially in accordance with the Uniform Guidance.

   c. The auditor expressed a modified opinion on the financial statements being prepared in accordance with GAAP.

   d. Substantial doubt about the entity's ability to continue as a going concern was not reported by the auditor.

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. Michele is determining materiality levels and assessing risks of material misstatement. Which of the three categories of the risk assessment process is she performing? **(Page 286)**

   a. Procedures performed. [This answer is incorrect. The procedures performed category of audit requirements relates to planning and includes inquiry, analytical procedures, inspection, observation, and other related planning activities and procedures. It does not include determining materiality and risk assessment.]

   b. Decisions and judgments made. [This answer is correct. 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 include determining materiality levels and assessing risks of material misstatement/noncompliance.]

   c. Understanding obtained. [This answer is incorrect. This category includes the auditor performing risk assessment procedures in order to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at both the financial statement and relevant assertion levels. It does not include the assessments and determinations Michele made in the scenario above.]

   d. Reporting in a single audit. [This answer is incorrect. Although the Uniform Guidance does require the auditor to report on each aspect of the audit, the reporting is not considered one of the three categories of the risk assessment process relating to planning the audit.]

2. The Hurst Independent School District expended $12 million in federal awards during the year. $10 million passed through the State Education Agency; the remainder came directly from the U.S. Department of Agriculture. Would the school district have a cognizant or oversight agency for their audit, and who would be the proper agency for the audit and reporting? **(Page 291)**

   a. The U.S. Department of Agriculture would be the oversight agency. [This answer is correct. Because the school district expended less than $50 million it would have an oversight agency. The federal agency that provided the predominant amount of direct funding would serve as the oversight agency. This would not be the State Education Agency since it is not a federal agency.]

   b. The U.S. Department of Agriculture would be the cognizant agency. [This answer is incorrect. Because the school district only expended $12 million during the year, it would require an oversight agency and not a cognizant agency for audit.]

   c. The State Education Agency would be the oversight agency. [This answer is incorrect. Although the school district received the majority amount of funding from the State Education Agency, this agency does not meet the qualifications to be the school district's oversight agency in this scenario.]

   d. The State Education Agency would be the cognizant agency. [This answer is incorrect. Because the school district expended less than $50 million during the year, it would have an oversight agency rather than a cognizant agency.]

3. Bob is performing a single audit and must determine the major programs. According to the Uniform Guidance, what is the first step Bob should perform in identifying major programs? **(Page 295)**

   a. Identify low-risk Type A programs. [This answer is incorrect. Section 200.518(c) of the Uniform Guidance requires the auditor to identify Type A programs that are low-risk. However, it is not the first step the auditor should perform, per the Uniform Guidance.]

   b. Identify high-risk Type B programs. [This answer is incorrect. Auditors must use professional judgment and the federal program risk criteria to identify high-risk Type B programs when determining major programs. However, this is not step one in the four-step process described in the Uniform Guidance.]

   c. Identify Type A and Type B programs. [This answer is correct. The Uniform Guidance describes a four-step process to determine major programs. Step 1 in this process is to identify programs as either Type A or Type B based on the classification system provided in Section 200.518(b) of the Uniform Guidance.]

   d. Determine major programs. [This answer is incorrect. Major programs are determined using the results of the risk analysis performed in Steps 2 and 3. This is the final step in the four-step process used to identify major programs under the Uniform Guidance.]

4. In order for an entity to be considered a low-risk auditee, it must meet certain criteria for each of the previous two audit periods. Which of the items below is one of the criteria specified in 2 CFR section 200.520? **(Page 301)**

   a. Less than five deficiencies in internal control were identified under Yellow Book requirements as material weaknesses. [This answer is incorrect. 2 CFR section 200.520 specifies that to be considered a low-risk auditee *no* deficiencies in internal control can be identified as material weaknesses under Yellow Book requirements.]

   b. Single audits were performed biennially in accordance with the Uniform Guidance. [This answer is incorrect. In order to be considered a low-risk auditee, single audits must be performed on an annual basis in accordance with the Uniform Guidance, including submitting the data collection form and reporting package to the federal audit clearinghouse within the earlier of 30 calendar days after the auditor's report is received or nine months after the end of the audit period.]

   c. The auditor expressed a modified opinion on the financial statements being prepared in accordance with GAAP. [This answer is incorrect. Entities must meet all criteria expressed in 2 CFR section 200.520 in order to be considered a low-risk auditee. One of these criteria is that the auditor's opinion on whether financial statements were prepared in accordance to GAAP, or a basis of accounting required by state law, be unmodified.]

   d. Substantial doubt about the entity's ability to continue as a going concern was not reported by the auditor. [This answer is correct. One of the criteria required in order for an auditee to be considered a low-risk under 2 CFR section 200.520 is that the auditor did not report substantial doubt about the entity's ability to continue as a going concern.]

STATE AND LOCAL COMPLIANCE REQUIREMENTS

In addition to the requirements of the Single Audit Act Amendments and the Uniform Guidance 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 compliance and reporting requirements that have a direct and material effect on the financial statements. To become familiar with state or local grant requirements, the auditor could:

- 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

Applicability of AU-C 935. When performing an audit of state or local grant activity, the auditor needs to determine whether AU-C 935 is applicable to the audit. AU-C 935, *Compliance Audits*, applies when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with *all* of the following—

- Generally accepted auditing standards;
- *Government Auditing Standards* requirements for financial audits; and
- A governmental audit requirement that requires an opinion on compliance. (A *governmental audit requirement* is a requirement established by law, regulation, rule, or provision of a contract or grant agreement that an entity obtain an audit of its compliance with applicable compliance requirements of one or more government programs it administers.)

If AU-C 935 is applicable, the auditor ought to follow the guidance for compliance audits.

Nature of Audit Requirements. If the auditor is engaged to perform an audit of state or local grant activity, including an audit of compliance with award requirements, the auditor should determine the nature of the audit

requirements (e.g., a single audit, an individual award audit, or an individual agency audit) and consider the relationship of the audit requirements to any federal audit requirements. In addition, the auditor ought to determine the nature of funding for audit costs. (The GAS/SA Audit Guide, Paragraph 5.25, indicates that costs of audits that are not conducted under the Uniform Guidance or that have been conducted but were not in accordance with the Uniform Guidance cannot be charged to federal awards.)

In instances where state (or local) awards must be subjected to single audit procedures, auditors need to give careful consideration to determination of major programs. Major programs for federal (including pass-through) grants are determined based solely on federal awards as defined in the Single Audit Act Amendments and the Uniform Guidance. The auditor could 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

State and local 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. A state or local grantor agency 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 needs to be careful not to issue a report that provides more assurance than is warranted by the scope of the audit. AU-C 935 applies to entities that are subject to the Single Audit Act and the Yellow Book. For practitioners' reports dated on or after May 1, 2017, where the entity is not subject to the Single Audit Act, the Uniform Guidance, and the Yellow Book, *Compliance Attestation* is codified by SSAE No. 18 AT-C 315 under the AICPA's clarified attestation standards. Engagements performed under AT-C 315, *Compliance Attestation*, must also comply with AT-C 105, *Concepts Common to All Attestation Engagements*, and the appropriate level of service standards at AT-C 200 (AT-C 215, *Agreed-Upon Procedures Engagements*, for agreed-upon procedures engagements that address compliance). AT-C 315 provides guidance to auditors who are requested to issue a report on an entity's compliance with laws and regulations.

Reports on Internal Control. The form of report on internal control prescribed by the Yellow Book may be appropriate, but state and local grantor agencies frequently require a different form of report. Some agencies may require a report that includes an *opinion* on the effectiveness of internal control. Historically, examinations of internal control have been performed under the AICPA Statements on Standards for Attestation Engagements. Under SAS No. 130, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*, 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) perform the examination in accordance with AU-C 940. SAS No. 130 was effective for integrated audits for periods ending on or after December 15, 2016.

AU-C 940 is not applicable to (a) an examination of only the suitability of the design of internal controls, (b) an examination of controls over the effectiveness and efficiency of operations, (c) an examination of controls over compliance with laws and regulations, (d) an engagement to report on controls of a service organization, or (e) 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-C 315 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 the Uniform Guidance. The state or other pass-through entity bears the responsibility for notifying the client of the source of funding. When the state or other organization is unable to identify how much of the pass-through funds

are federal, the total amount is included in the schedule and a note to the schedule describes the commingled nature of the funds. In addition, the GAS/SA Audit Guide, Paragraph 12.39, 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 or material weakness in internal control over compliance should be reported and (b) whether material noncompliance (for subrecipient monitoring) should be reported.

RISK ASSESSMENT AND OTHER PLANNING PROCEDURES

In a financial statement audit, under both GAAS and *Government Auditing Standards*, the auditor is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by error or fraud. AU-C 250.A10 indicates that the auditor's responsibility for detecting misstatements resulting from violations of laws and regulations that have a direct and material effect on the financial statement amounts and disclosures is the same as that for misstatements caused by errors and fraud. In addition, the auditor is required to perform specific procedures to identify potential noncompliance with laws and regulations that may have a material indirect effect on the financial statements. The Yellow Book, at Paragraph 4.06, states that the auditor "should extend the AICPA's requirements pertaining to the auditors' responsibilities for laws and regulations to also apply to consideration of compliance with provisions of contracts or grant agreements."

The Uniform Guidance extends this concept and requires the auditor to also determine whether the auditee has complied with federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on each major program. Accordingly, when developing the audit plan, the auditor assesses not only the risk that noncompliance may cause the financial statements to contain a material misstatement, but also the risk that noncompliance may have a material effect on each major program. The auditor also must consider risk factors related to (a) the risk of noncompliance with those federal statutes, regulations, and the terms and conditions of federal awards and (b) the related control activities designed to prevent or to detect such noncompliance. The auditor also specifically assesses both the risk of material misstatement of the financial statements and the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. The auditor considers that assessment when designing the audit procedures to be performed.

AU-C 315.05 explains that the auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at both the financial statement and relevant assertion levels. Risk assessment procedures are focused toward gathering and evaluating information about the client and are not specifically designed as tests of controls or substantive procedures. Risk assessment procedures alone do not provide sufficient appropriate audit evidence on which to base an opinion. In all circumstances, further audit procedures are necessary to support an opinion.

AU-C 935.15 also establishes a requirement to perform risk assessment procedures. It states that the auditor should perform risk assessment procedures to obtain an understanding of applicable compliance requirements and related internal control over such compliance requirements for each program and compliance requirement selected for testing. The procedures should include:

- Inquiring of management about whether reports or other written communications from previous audits, attestation engagements, and internal or external monitoring have findings and recommendations that directly relate to the objectives of the compliance audit.

- Obtaining an understanding of management's response (for example, corrective actions) to findings and recommendations that could have a material effect on compliance with applicable compliance requirements.

- Using the information obtained about the findings and recommendations to assess risk and determine the nature, timing, and extent of compliance audit procedures, including procedures to test corrective actions.

Paragraph 6.30 of the GAS/SA Audit Guide explains that obtaining an understanding of the major program, the direct and material compliance requirements, and internal control over compliance establishes a frame of reference within which the auditor plans the compliance audit and exercises professional judgment regarding assessing risks of material noncompliance and responding to those risks during the audit.

The GAS/SA Audit Guide, Paragraph 6.31, and AU-C 935.A13 explain that the nature and extent of risk assessment procedures may vary for different entities and are influenced by factors such as the following:

- The newness and complexity of the applicable compliance requirements.
- The nature of the applicable compliance requirements.
- The auditor's knowledge of the entity's internal control over compliance with the applicable compliance requirements obtained in previous audits or other engagements.
- The services provided by the entity and how external factors affect the services.
- The amount of oversight by the grantor or pass-through entity.
- The ways management addresses audit findings.

In a Uniform Guidance compliance audit, the applicable compliance requirements are those that may have a direct and material effect on each major program (i.e., the "direct and material compliance requirements").

Assessing Risk of Material Noncompliance

Financial Statement Audits. 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 should design the audit to provide reasonable assurance of detecting such noncompliance. The GAS/SA Audit Guide, Paragraph 3.47, states that the auditor should obtain an understanding of relevant provisions of laws, regulations, contracts, and grant agreements and how the entity is complying with them. In addition, the auditor should perform procedures that may identify instances of noncompliance with provisions of laws, regulations, contracts, and grant agreements that may have a material effect on the financial statements. Paragraph 3.47 identifies the following procedures that are among those 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.
- Review the relevant parts of directly related agreements, such as grant and debt agreements.
- Obtain an understanding from management about the sources of revenue, review related agreements, and inquire about overall governmental regulations on accounting for the revenue.
- 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 that address financial reporting, investments, debt, taxation, 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 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 program compliance requirements, such as information in the *OMB 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 finance personnel or program administrators about grant restrictions, limitations, terms, and conditions.

The GAS/SA Audit Guide cautions auditors that they "should remain alert to the possibility that other audit procedures applied may bring instances of noncompliance to the auditor's attention."

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.

Compliance Audits. As part of assessing the risks of material noncompliance in a Uniform Guidance audit, the auditor assesses both the risk that noncompliance may cause the financial statements to contain a material misstatement and the risk that noncompliance may have a material effect on each major program. Paragraph 6.40 of the GAS/SA 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 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.

AU-C 935.15–.16 also requires the auditor to perform risk assessment procedures, which should include the following:

- Inquiring of management about whether reports or other written communications from previous audits, attestation engagements, and internal or external monitoring have findings and recommendations that directly relate to the objectives of the compliance audit.
- Obtaining an understanding of management's response (e.g., corrective actions) to findings and recommendations that could have a material effect on compliance.
- Using the information obtained about the findings and recommendations to assess risk and determine the nature, timing, and extent of compliance audit procedures, including procedures to test corrective actions.

AU-C 935.17 states that, for each applicable compliance requirement, the auditor should assess the risks of material noncompliance, whether due to error or fraud, and consider whether any risks might affect multiple compliance requirements (that is, whether the risks are pervasive). For example, there might be a pervasive risk of noncompliance if the entity has financial difficulties that present an increased risk of grant funds being used for unauthorized purposes, or if the entity has poor record-keeping for government programs. The auditor should develop an overall response to any pervasive risks of material noncompliance that are identified. A list of factors to consider when assessing the risks of material noncompliance in a compliance audit is provided later in this lesson.)

Assessing Risks of Material Noncompliance Due to Fraud. The auditor should specifically assess fraud risk throughout the audit. In the context of a Uniform Guidance audit of compliance, fraud risk is the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. It relates to fraudulent acts that may result in material noncompliance with a major federal program's compliance requirements or in the misappropriation of federal funds.

Significant Risks

AU-C 315.28 and the GAS/SA Audit Guide, Paragraph 3.31, indicate that as part of the risk assessment process, the auditor should determine whether any of the risks identified are significant risks. This judgment excludes the effects

of identified controls related to the risk. The GAS/SA Audit Guide, Paragraph 3.31, mentions that AU-C 315.29 provides considerations relating to identifying significant risks. If a significant risk exists, the auditor should obtain an understanding of the entity's controls, including control activities, relevant to the risk. Based on that understanding, the auditor should evaluate whether the controls have been suitably designed and implemented to mitigate the significant risk.

The AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (AICPA Risk Assessment Audit Guide), Paragraph 5.31, notes that in most audits, one or more significant risks normally arise. It observes with respect to the determination of significant risk that, in a situation in which the auditor assesses inherent risk as high, moderate, or low, a significant risk would be one that is higher than high and, thus, requires special audit consideration. The auditor determines whether the risk is such that it requires special audit consideration by focusing on the following:

- The nature of the program and related risks.
- The likely magnitude of the potential misstatement or noncompliance, including the possibility of multiple misstatements or instances of noncompliance.
- The likelihood of misstatements or noncompliance occurring.

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

According to AU-C 315.29, the nature of the risks should be evaluated by considering the following:

- Is the risk a risk of fraud?
- Is the risk related to recent significant economic, accounting, program, or other developments?
- Are the transactions or compliance requirements complex?
- Does the risk involve significant transactions with related parties?
- Is there a relatively large degree of subjectivity involved?
- Does the risk involve significant transactions outside the normal course of business or that otherwise appear unusual?

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. Paragraph 5.31 of the AICPA Risk Assessment Audit Guide suggests that it may be helpful to compare all high inherent risks to assist with the identification of significant risks.

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

- Significant nonroutine transactions, i.e., 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.
- Financial statement items for which management judgments (such as judgments about when it is appropriate to recognize revenue, management's intended future actions, or the likelihood of a future event) may affect recognition, classification, or disclosure.

- 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 AICPA Risk Assessment Audit Guide (Paragraph 5.31) cautions that the unnecessary designation of too many risks as significant risks can impair the efficiency of the audit. Also, if the auditor plans to rely on the operating effectiveness of controls relating to a significant risk, the auditor cannot use evidence obtained in prior periods about the effectiveness of such controls.

The identification of risks as significant risks has important implications for further audit procedures, including tests of controls. Once the auditor has identified a risk as a significant risk, the auditor would ordinarily 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 (required by AU-C 315.30).
- 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.
- Perform substantive procedures that are specifically responsive to the risk. If the auditor does not plan to rely on the controls and is performing only substantive procedures, the substantive procedures need to be tests of details only or a combination of tests of details and substantive analytical procedures. (AU-C 330.22 explains that when there are significant risks at the relevant assertion level, substantive procedures should include tests of details when the response consists only of substantive procedures.)
- Document the significant risks identified and related controls evaluated (required by AU-C 315.33).

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.

Risk Assessment Procedures

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*.

Types of Risk Assessment Procedures. AU-C 300 and AU-C 315 specifically identify the following as necessary risk assessment and other planning procedures:

a. Preliminary engagement activities, including establishing an understanding with the client.

b. Inquiries of management, internal audit (if applicable), and others within the organization and those charged with governance.

c. Analytical procedures.

d. Observation and inspection. [Examples of such procedures include visits to the entity's premises and tracing transactions through the information system (that is, walkthroughs).]

e. Discussion among the engagement team.

All of the risk assessment procedures are performed when obtaining an understanding of the entity and its environment. However, each of those procedures need not be performed for every component of the understanding outlined later in this lesson. 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. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement is required by AU-C 315.11. Additionally, AU-C 240.15 expands on the discussion as it relates to brainstorming about susceptibility to material misstatement due to fraud.

AU-C 935.15–.16 establishes specific risk assessment procedures that should be performed in an audit of compliance. Those procedures are discussed previously in this lesson.

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 need tailoring in response to the information gathered. For example, in all audits the auditor will make inquiries of management about the risks of fraud. However, determining others within the entity to whom similar 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 Information Needed to Identify Fraud Risks. The GAS/SA Audit Guide, Paragraph 6.41, 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, the auditor may become aware of information that is relevant to identifying fraud risks. In addition, AU-C 240.17–.24 explains that 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 analytical procedures.
- Consider the existence of fraud risk factors.
- Consider certain other information, such as identified inherent risks, 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.

An in-depth discussion of fraud considerations is provided later in this lesson.

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? Similarly, can information obtained from the auditor's previous experience with the client be used in identifying risks of material misstatement? The answer to both questions is a qualified "yes."

The process of understanding the 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, controls, and operations.

- Past misstatements and noncompliance and whether they were corrected on a timely basis.
- Significant changes from the prior period.

Information about past misstatements and noncompliance assists the auditor in assessing risks in the current audit. Before using information obtained in prior periods, however, AU-C 315.10 requires auditors to ascertain whether changes have occurred since the last audit that may be relevant in the current audit. Because such changes may affect the client's operating risk or the auditor's assessment of risks of material misstatement or noncompliance, the auditor needs to perform some risk assessment procedures in the current audit to determine whether changes have occurred that impact the relevance of information gathered in previous audits. For example, the auditor might perform inquiries of client management and key client personnel, including personnel outside of the accounting department or other parties, supplemented by observation and inspection (for example, review of interim financial reports and budgets and walkthroughs) to determine if changes have occurred.

Risk assessment procedures are discussed in greater detail in *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Audits of Nonprofit Organizations*.

Inquiries of Management and Others

Inquiry of management and others is used extensively throughout the audit planning process. AU-C 315.06 specifically requires the auditor to make inquiries of management and others within the entity who may have information that is likely to help in the identification of risks of material misstatement whether due to error or fraud. In many cases, inquiry 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. GAAS require the auditor to inquire of management, internal audit (if such a function exists), and others in the organization about the following matters relevant to audit planning:

a. The entity and its environment as enumerated in AU-C 315 and explained later in this lesson.

b. Fraud-related matters as enumerated in AU-C 240.

c. Reports or other written communications from previous audits, attestation engagements, and internal or external monitoring that have findings and recommendations directly related to the objectives of the compliance audit as enumerated in AU-C 935.16.

d. Accounting estimates as enumerated in AU-C 540.

e. Related parties and related-party transactions as enumerated in AU-C 550.

In addition to inquiries of management and those charged with governance, inquiries of others within and outside the entity are either required or can provide useful information. Examples of inquiries of others include the following:

a. *Those Charged with Governance.* Their involvement in the financial reporting process and how the financial statements are used. AU-C 240.21 requires the auditor to inquire directly of those charged with governance (or the audit committee, or at least its chair) about the risks of fraud and knowledge of actual, suspected, or alleged fraud.

b. *Internal Audit.* Activities concerning the design and effectiveness of internal control and management's responses to any findings by the internal audit function. AU-C 315.06 requires inquiries of appropriate internal audit personnel who may have information on risks of material misstatement due to fraud or error, or who can assist in identifying such risks. AU-C 240.19 requires inquiry of internal audit personnel about risks of fraud; knowledge of actual, suspected, or alleged fraud; and activities concerning fraud detection, and whether management satisfactorily responded to any findings.

c. *Other Employees.* Their role in the financial reporting process and additional or corroborating information to support management's responses. AU-C 240.A18–.A19 and AU-C 315.A7 include discussions of the benefits of inquiry and provide examples of others within the entity to whom the auditor may direct inquiries

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. 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. AU-C 240.32 explicitly requires inquiries about knowledge of inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

(2) *Compliance Officers, or Grant or Contract Administrators.* Their understanding of the applicable compliance requirements and the entity's compliance with the requirements.

(3) *In-house Legal Counsel.* Litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud, and the meaning of contract terms.

(4) *IT Systems Personnel or 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.

(5) *Risk Management Personnel.* Information about operating, regulatory, and other risks that may affect financial reporting.

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 the office of the federal, state, or local program official or auditor; other appropriate audit oversight organizations or regulators; or external legal counsel that management has engaged.

Fraud-related Inquiries. The inquiries of management made in audit planning, according to AU-C 240.17–.18, should include the following specific areas of inquiry:

a. Whether they have knowledge of any actual, suspected, or alleged fraud.

b. Management's process for identifying, responding to, and monitoring the risks of fraud in the entity.

c. The nature, extent, and frequency of management's assessment of fraud risk and the results of those assessments.

d. Any specific risks of fraud that management has identified or that have been brought to its attention.

e. The classes of transactions, account balances, or disclosures for which a fraud risk is likely to exist.

f. Management's communications, if any, to:

- Those charged with governance on its process for identifying and responding to fraud risks.
- Employees on their views on appropriate business practices and ethical behavior.

The areas of inquiry required by AU-C 240 include management's processes and assessment methods, as well as knowledge of identified risks or actual, suspected, or alleged fraud. Naturally, auditors give more weight to information about risks and knowledge of fraud if management has effective processes and assessment methods. However, AU-C 240.A20 notes that management is often best situated to perpetrate fraud. Thus, the responses of members of senior management concerning the likelihood of perpetration of fraud by themselves are far less meaningful than with respect to perpetration by lower levels within the entity. The objective of the inquiry includes obtaining different perspectives on financial statement areas and organizational areas and locations with a risk of fraud and identifying whether anyone has suspicions or actual knowledge of fraud.

Additional *Government Auditing Standards* Requirements. *Government Auditing Standards* indicates that auditors should 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 4.05, 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 should use this information when assessing risk and determining the nature, timing, and extent of audit work, including the testing of implementation of corrective actions. (AU-C 935 has similar requirements for findings that could have a material effect on compliance.)

Documentation. AU-C 935.39 states that the auditor's documentation should include the risk assessment procedures performed, including those related to obtaining an understanding of internal control over compliance. AU-C 230.09 states that in documenting the nature, timing, and extent of audit procedures, the auditor should record the identifying characteristics of the items or matters tested. AU-C 230.A14 suggests that, for a procedure involving inquiries of entity personnel, the auditor records the inquiries made, the dates of inquiries, and the names and job designations of the personnel. It is best practice to document such matters when performing risk assessment inquiry procedures.

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. According to AU-C 315.A139, documentation for entities that have uncomplicated businesses and processes relevant to financial reporting, may be simple and relatively brief.

Inquiries of management and others are discussed in greater detail in *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Audits of Nonprofit Organizations*.

Analytical Procedures

AU-C 315 specifies that the risk assessment procedures should include analytical procedures. It further notes that analytical procedures performed as risk assessment procedures may include both financial and nonfinancial information. AU-C 315.A15–.A16 explains that unusual or unexpected relationships identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud, but when analytical procedures use data aggregated at a high level, the results provide only a broad initial indication about whether a material misstatement may exist.

AU-C 935 Guidance on Analytical Procedures. AU-C 935.A23 explains that using analytical procedures to gather substantive evidence is generally less effective in a compliance audit than it is in a financial statement audit. However, substantive analytical procedures may contribute some evidence when performed in addition to tests of transactions and other auditing procedures necessary to provide the auditor with sufficient appropriate audit evidence. AU-C 935.19 states that risk assessment procedures, tests of controls, and analytical procedures alone are not sufficient to address a risk of material noncompliance. The auditor should also design and perform further audit procedures, including tests of details (which may include tests of transactions) to obtain sufficient appropriate audit evidence about the entity's compliance with each of the applicable compliance requirements in response to the assessed risks of material noncompliance.

Analytical Procedures Related to Revenue. AU-C 240.22 requires that, to the extent they are not already included, analytical procedures should include procedures related to revenue. Auditors 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 needs to 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 have been considered when identifying fraud risks.

Observation and Inspection

According to AU-C 315.06, risk assessment procedures should include observation and inspection. 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. AU-C 230.09 requires that in documenting the nature, timing, and extent of audit procedures, the auditor should record the identifying characteristics of the specific items or matters tested. AU-C 230.A14 provides examples of how this might be accomplished. Based on that guidance, practitioners should consider documenting 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

AU-C 315.11 requires key members of the audit team, including the engagement partner, to discuss the susceptibility of the entity's financial statements to material misstatements. AU-C 315.11 also requires discussion of the applicability of GAAP to the entity's facts and circumstances. AU-C 240.15 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. However, it is important that the auditor consider the susceptibility to fraud as a distinct part of this combined discussion to avoid the potential dilution of this critical consideration.

The GAS/SA Audit Guide, Paragraph 6.43, indicates that in a compliance audit, the focus of the audit team discussion would be on the individual members gaining a better understanding of the potential for material noncompliance resulting from fraud. Depending on the number of major programs and the size of the audit team, it might be most effective to hold a separate meeting for each major program or groups of major programs audited by a portion of the audit team.

Matters to Be Discussed. The discussion is aimed at the susceptibility to material misstatement or noncompliance and the application of GAAP to the entity's facts and circumstances; that is, the areas of vulnerability. The discussion is one of the sources of information used to assess the risks of material misstatement or noncompliance. Thus, the discussion ought to open the minds of members of the audit team to potential material misstatements or noncompliance from error and, particularly, from fraud. Any high risk areas that have already been identified, however, should also be communicated to the team members.

The engagement team is specifically required to discuss the following:

- Information about the engagement provided by the engagement partner as part of his or her responsibility to direct the engagement.

- Related-party relationships and transactions.
- Areas susceptible to management override of controls.
- The susceptibility of the entity's financial statements to material misstatement.
- The susceptibility of the entity's major programs to direct and material noncompliance with compliance requirements.
- The need to exercise professional skepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement or noncompliance due to fraud or error may have occurred, and to be rigorous in following up on such indications.
- Application of GAAP to the entity's facts and circumstances in light of its accounting policies.
- Fraud-related matters, including how management might conceal fraud.
- How assets could be stolen.
- How the engagement team might respond to the susceptibility of the entity's financial statements, schedule of federal expenditures of federal awards, or major programs to material misstatement or noncompliance due to fraud.

In addition, focusing on the areas of vulnerability, the engagement team discussion might include the following topics:

a. Critical issues and areas of significant audit risk.

b. Unusual accounting practices used by the client.

c. Major programs, including the entity's experience with each of them.

d. Direct and material compliance requirements.

e. Important control systems.

f. Significant IT applications and how the use of IT may affect the audit.

g. Materiality at the financial statement level (planning materiality) and at the account level (performance materiality), as well as materiality for each major federal awards program.

h. How materiality will be used to determine the extent of testing.

Examples of other factors that affect the likelihood of material misstatements or noncompliance that the engagement team might discuss include the following:

- Past experience with the client (including areas with audit difficulty and misstatements or noncompliance encountered).
- 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.
- The complexity of the direct and material compliance requirements.

- The susceptibility of the direct and material compliance requirements to noncompliance.
- The length of time the entity has been subject to the direct and material compliance requirements.
- The auditor's knowledge about how the entity complied with the direct and material compliance requirements in prior years.
- The potential effect on the entity of noncompliance with the direct and material compliance requirements.
- The amount of judgment involved in meeting the compliance requirements.
- The effect on the compliance audit of the auditor's assessment of the risks of material misstatement in the financial statement audit.

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.

Engagement Partner Information. AU-C 220.17 requires the engagement partner to take responsibility for the direction, supervision, and performance of the audit engagement, while AU-C 220.A12 further clarifies that direction of the engagement team involves informing team members of certain matters. The engagement partner informs the engagement team of matters such as the following:

- Their responsibilities, including complying with relevant ethical requirements and applying professional skepticism when planning and performing the audit.
- If more than one partner is involved with the engagement, each of their responsibilities.
- Objectives of the work to be performed.
- Nature of the entity's activities and federal award programs.
- Risk-related issues.
- Problems that could arise.
- Detailed audit approach to performing the engagement.

Related Parties. AU-C 550.13 specifically requires auditors, as part of the engagement team discussion, to consider how related-party relationships and transactions could affect the susceptibility of the financial statements to material misstatement. AU-C 550.A7–.A8 indicates that the team discussion might discuss the following related-party matters:

- Nature and extent of the entity's relationships and transactions with related parties.
- Importance of maintaining professional skepticism regarding related parties throughout the audit.
- Circumstances or conditions that may indicate the existence of unidentified related-party relationships or transactions.
- Types of records or documents that might indicate the existence of related-party relationships or transactions.
- Importance that management and those charged with governance attach to the identification of, accounting for, and disclosure of related-party relationships and transactions and the related risk of management override.

- How related parties might be involved in fraud.

It is recommended that the discussion include reminding the engagement team that if related parties or significant related party transactions are identified by the auditor that were not previously identified and disclosed by management, the engagement team is required by AU-C 550.23 to promptly communicate such information to other team members. Also, AU-C 550.23 requires that the auditor inquire of management as to why applicable controls over related party relationships and transactions failed to identify and disclose such information.

Fraud-related Matters. AU-C 240.15 indicates that the discussion should also 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 the entity's assets could be stolen.
- External and internal factors that might create incentives/pressures, provide opportunities, or enable rationalization of fraud.
- Risk of management override of controls.
- Circumstances that might be indicative of manipulation of the budget or other financial measures.
- Practices management might use to manipulate the budget or other financial measures that could lead to fraudulent financial reporting.
- How the auditor might respond to the susceptibility of the financial statements to material misstatement due to fraud.
- Importance of maintaining professional skepticism regarding potential for material misstatement due to fraud.

Documentation. AU-C 315.33 requires that the following items be documented regarding the discussion among the audit team:

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

AU-C 240 imposes similar documentation requirements related to fraud aspects of the discussion.

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.

Engagement team discussions are discussed in greater detail in *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Audits of Nonprofit Organizations*.

Other Risk Considerations

Considering Risk of Material Misstatement Due to Noncompliance with Laws and Regulations. According to AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, the auditor's objective when

considering laws and regulations during the planning stage of an audit of the financial statements is to obtain audit evidence for material amounts and disclosures that are *directly* determined by the provisions of laws and regulations. In addition, the auditor is required to perform specific procedures, including inquiry and inspection of correspondence with licensing or regulatory authorities, to identify potential noncompliance with laws and regulations that may have a material *indirect* effect on the financial statements.

AU-C 250.06 distinguishes the auditor's responsibilities between the following two categories of laws and regulations:

a. *Provisions with a Direct Effect.* The provisions of laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as accruals and expenses affected by revenue recorded under government contracts. AU-C 250.A10 indicates that the auditor's responsibility for detecting misstatements resulting from violations of laws and regulations having a direct and material effect on the determination of financial statement amounts and disclosures is the same as that for misstatements caused by errors and fraud.

b. *Provisions of Other Laws and Regulations.* The provisions of other laws and regulations that do not have a direct effect on the determination of amounts and disclosures in the financial statements. However, compliance with those other laws and regulations may be fundamental to the operating aspects of the entity, fundamental to an entity's ability to continue as a going concern, or necessary for the entity to avoid material penalties. Examples include compliance with an entity's operating license and with laws or regulations related to occupational safety and health, food and drug administrations, etc. In addition to inquiring of management about whether the entity is in compliance with other laws and regulations, AU-C 250.14 requires the auditor to inspect any correspondence with the relevant licensing or regulatory authorities.

Applicability to a Compliance Audit. Single audits are subject to the requirements of AU-C 935, *Compliance Audits*. The footnote to Paragraph 3.43 of the GAS/SA Audit Guide states that AU-C 250 applies only to financial audits and does not apply to compliance audits performed under AU-C 935. Consideration of laws and regulations in a single audit performed under the Uniform Guidance is addressed in Part II of the GAS/SA Audit Guide, which includes guidance from AU-C 935, the Uniform Guidance, and other sources.

Considering Risk of Material Misstatement Due to Abuse. The Yellow Book contains an additional fieldwork standard that requires auditors performing an audit in accordance with *Government Auditing Standards* to perform additional procedures if they become aware of material abuse. As with all of the Yellow Book's standards for a financial statement audit, this requirement also applies to a Uniform Guidance compliance audit. The GAS/SA Audit Guide, Paragraph 5.18, clarifies that if the auditor becomes aware of abuse that could be quantitatively or qualitatively material to the financial statements or to one or more major programs, the auditor should perform additional procedures to determine the potential effect on the financial statements or major program(s). Auditors have no responsibility to plan audits to detect abuse.

UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

According to AU-C 315, the auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion level. The auditor's focus in obtaining the understanding is on attaining a knowledge level sufficient to identify the risks of material misstatement of the financial statements 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.

The Uniform Guidance, at 2 CFR section 200.303, requires nonfederal entities to establish and maintain effective internal control over federal awards that provides reasonable assurance federal awards are managed in compliance with federal statutes, regulations, and the terms and conditions of the federal awards. It goes on to state that the internal controls should be in compliance with guidance in *Standards for Internal Control in the Federal Government*

(the "Green Book") or with COSO's Internal Control—Integrated Framework. The auditor is required to perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk of noncompliance for major programs. To do so, the auditor needs to understand the assertions relevant to the compliance requirements for each major program. Obtaining this knowledge allows the auditor to understand 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. The auditor obtains this knowledge through inquiries of client management and other personnel, inspection of documents and records, and observation of activities and operations, as well as through previous experience with the client.

Because the Uniform Guidance requires the auditor to determine whether the recipient has complied with federal statutes, regulations, and the terms and conditions of federal awards 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 is 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, to assess the risk of material noncompliance with federal statutes, regulations, and the terms and conditions of federal awards relevant to each major federal award program, 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 that may result in a material misstatement or noncompliance.

d. Measurement and review of federal award program performance.

e. Selection and application of accounting policies.

f. Fraud risk factors.

Documentation. AU-C 315.33 indicates that auditors should document:

- Key elements of the understanding obtained for each of the aspects of the entity and its environment.
- Sources of the information from which the understanding was obtained.
- Risk assessment procedures that were performed.

The GAS/SA Audit Guide, Paragraph 9.60, explains that in a compliance audit, the documentation of the risk assessment procedures performed would include those related to gaining an understanding of internal control over compliance.

Industry, Regulatory, and Other External Factors

AU-C 315.12 indicates that 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 or noncompliance 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.

Possible Risk Assessment Procedures and Factors to Consider. It is likely that 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 should read correspondence from regulatory authorities and might also review applicable regulations that were recently enacted, proposed legislation that may affect the client, 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.

The GAS/SA Audit Guide, Paragraph 6.30, states that for each of the major programs and direct and material compliance requirements selected for testing, the auditor should perform risk assessment procedures to obtain an understanding of the direct and material compliance requirements and internal control over compliance with those requirements. In addition, the auditor must design the audit to provide reasonable assurance of detecting instances of noncompliance with federal statutes, regulations, and the terms and conditions of federal awards 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 statutes, regulations, and the terms and conditions of federal awards on the entity's financial statements and on the entity's major programs. Paragraph 6.30 of the GAS/SA Audit Guide explains that obtaining an understanding of the major programs, the direct and material compliance requirements, and internal control over compliance establishes a frame of reference within which the auditor plans the compliance audit and exercises professional judgment regarding assessing the risks of material noncompliance and responding to those risks during the audit.

Identifying Programs and Compliance Requirements to Test. AU-C 935.14 clarifies that management is responsible for identifying an entity's government programs and understanding and complying with their compliance requirements. However, the auditor should determine which government programs and compliance requirements to test (i.e., the applicable compliance requirements). AU-C 935 cites the Compliance Supplement as a framework for determining applicable compliance requirements. In a Uniform Guidance compliance audit, the applicable compliance requirements are those that may have a direct and material effect on each major program (i.e., the "direct and material compliance requirements").

The GAS/SA Audit Guide, Paragraph 6.24, explains that the Compliance Supplement is the primary source for identifying compliance requirements for federal programs. The Uniform Guidance itself states that the auditor must follow the guidance in Part 7 of the Compliance Supplement for programs not included in the Compliance Supplement. According to Paragraph 10.31 of the GAS/SA Audit Guide, to identify the compliance requirements to test and report on for programs not included in the Compliance Supplement, the auditor should:

- Use the 12 types of compliance requirements in the Compliance Supplement as a guide for identifying the types of compliance requirements to test.

- Review the terms and conditions of federal awards and the federal statutes and regulations referred to therein.

- Follow the guidance in Part 7 of the Compliance Supplement, which lists the following steps for the auditor to perform:

    a. Identify the compliance requirements that are applicable to the program.

    b. Determine which of the compliance requirements that the auditor identified could have a direct and material effect on the major program.

    c. Determine which of the compliance requirements that could have a direct and material effect are susceptible to testing by the auditor.

    d. For each direct and material compliance requirement that is susceptible to testing, determine into which of the 12 types of compliance requirements it falls.

    e. For special tests and provisions, determine the applicable audit objectives and audit procedures.

Part 7 of the Compliance Supplement, as well as the application guidance at AU-C 935.A10–.A11, provide detailed guidance on applying the above steps, such as reviewing the CFDA, consulting an audit guide issued by the federal awarding agency, and discussing the program with management and other knowledgeable individuals (both inside and outside the entity).

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, such as 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 might 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.

AICPA Audit Risk Alert on General Economic Matters. The AICPA Audit Risk Alert, *General Accounting and Auditing Developments—2016/17* helps auditors identify and respond to accounting and audit issues related to economic developments. The risk alert emphasizes the importance of understanding economic conditions facing the industry and the entity. The Alert notes that, in a changing economic environment, auditors need to evaluate how changes that have occurred since the previous audit affect their reliance on information obtained from prior experience with the client. Changes in the economy and regulatory environment often complicate the auditor's responsibility related to obtaining that understanding. For example, changed conditions may require the auditor to reconsider his or her understanding about how the economic environment affects the entity, reassess audit risks, and modify planned audit procedures as the audit progresses.

AICPA Audit Risk Alert for Single Audits. The AICPA Audit Risk Alert, *Government Auditing Standards and Single Audit Developments—2016/17* provides an extensive overview of the Uniform Guidance and in-depth discussions of related audit considerations. The risk alert also discusses the extensive changes in the 2016 *OMB Compliance Supplement*, and provides an update on Federal Audit Clearinghouse activities. The Risk Alert also includes a discussion of what auditors can do to prepare for the study of audit quality, which the Uniform Guidance requires

to be performed once every six years beginning in 2018. In addition, the Risk Alert includes a summary of audit deficiencies found in recent peer reviews of Single Audits.

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 federal statutes, regulations, and the terms and conditions of federal awards as well as a report on the schedule of expenditures of federal awards. The additional reporting requirements for a single audit are discussed in detail in *PPC's Guide to Single Audits*.

Risk Assessment Procedures and Factors to Consider. In most situations, auditors will initially gather information and identify risks related to industry, regulatory, and other external factors through inquiry procedures. Many of the matters to be addressed are best approached through inquiry of appropriate client management, including program management, and other employees. The auditor may need to expand inquiries based on the client's responses to more fully understand the area and follow up on information that may be indicative of a potential risk.

Nature of the Entity

AU-C 315.12 indicates 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. The effects of these characteristics need to 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 sections of GAAS, 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 federal statutes, regulations, and the terms and conditions of federal awards, other agreements, audit documentation about applicable compliance requirements from previous professional engagements, and minutes of governing board meetings, 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 obtains copies of all available subrecipient audit reports. The GAS/SA Audit Guide, Paragraph 12.29, explains that the pass-through entity should have internal controls in place to determine that subrecipient audit reports have been obtained and that corrective action has been taken. If the subrecipient's audit report is current, it does not have to cover the same period as the pass-through entity.

Auditors need to be aware of the subrecipient's monitoring procedures, such as limited scope engagements. While auditing subrecipients is not a required part of auditing a pass-through entity, the pass-through entity may ask the auditor to perform procedures beyond the scope of the Uniform Guidance compliance audit to determine whether the subrecipient is in compliance with one or more compliance requirements. The GAS/SA Audit Guide, Paragraph 12.37, explains that the additional procedures would generally be performed as a separate engagement.

Risk Assessment Procedures and Factors to Consider. Similar to the understanding of industry, regulatory, and other external factors, the auditor often initially makes inquiries of appropriate client personnel about matters pertaining to the nature of the entity and its federal award programs. To make effective risk-based inquiries, it is critical to identify the right person within the entity who 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

AU-C 315.12 indicates that the auditor should obtain an understanding of the entity's objectives, strategies, and business risks, including those 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 business 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 related business 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 business 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 related business 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 and inspect the reports that are used to monitor performance and compliance.

For all situations, the auditor might inquire as to 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

AU-C 315.12 states that the auditor should obtain an understanding of the entity's selection and application of accounting policies and evaluate whether the policies are appropriate. Gaining an understanding of the selection and application of accounting policies is important for considering the risks of material misstatement and noncompliance, including misstatements and noncompliance due to fraud and error.

Risk Assessment Procedures and Factors to Consider. For many entities, the auditor is instrumental in assisting with selection of accounting principles and 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. For other situations in which the auditor is not involved in the selection of accounting policies or has limited experience with the client, the auditor may supplement inquiries with a review of interim or prior year financial statements and supporting disclosures (for initial audits) coupled with a thorough review and understanding of relevant accounting standards that are either new or specifically applicable to the client's industry or its transactions.

Fraud Risk Factors

AU-C 240.24 states that the auditor should evaluate whether the information obtained from risk assessment procedures indicates that one or more fraud risk factors are present. Fraud risk factors are events or conditions that indicate an incentive or pressure to perpetrate fraud, provide an opportunity to commit fraud, or indicate attitudes or rationalizations to justify a fraudulent action.

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 needs to 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.

Examples of Fraud Risk Factors. AU-C 240.A75 provides examples of fraud risk factors that may be considered when identifying and assessing the risks of material misstatement due to fraud. The risk factors are classified 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 standard further classifies the illustrative risk factors 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.

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 is 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 or noncompliance occurs.

The GAS/SA Audit Guide, Paragraphs 6.41–.42, explain that in a compliance audit, the auditor's risk assessment process should include assessing the risks of material noncompliance with a major program's compliance requirements occurring due to fraud. The fraud risk assessment is relative to fraudulent acts that might result in material noncompliance with a major program's compliance requirements or the misappropriation of federal funds.

The GAS/SA Audit Guide, Paragraph 6.43, suggests that, as part of determining fraud risk factors for major programs, the auditor considers the results of the financial statement fraud risk assessment to determine the applicability of those results to the compliance audit. The auditor assesses whether those risk factors, individually or in combination, present a risk of material noncompliance with compliance requirements that could have a direct and material effect on a major federal program.

If fraud risks are present, the auditor considers whether the assessment of the risk of material misstatement or noncompliance due to fraud calls for an overall response, one that is specific to a particular account balance, class of transactions, or disclosures 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.

5. Auditors need to determine whether AU-C 935 is applicable when performing an audit of state or local grant activity. This standard applies when the auditor is either engaged or required by law or regulation to perform a compliance audit in accordance with what requirements?

    a. Generally accepted auditing standards, *Government Auditing Standards,* and a governmental audit requirement requiring an opinion on compliance.

    b. Generally accepted accounting principles, *Government Auditing Standards,* and governmental requirements requiring compliance opinions.

    c. *Government Auditing Standards* and a governmental audit requirement requiring a compliance opinion.

    d. Generally accepted auditing standards, *Government Auditing Standards,* and the Internal Revenue Code.

6. Which of the following factors may influence the nature and extent of risk assessment procedures for an entity during a single audit?

    a. The level of personnel involved in the compliance-assurance process.

    b. The age and complexity of the applicable compliance requirements.

    c. The ways management addresses customer complaints.

    d. How likely it is noncompliance will occur.

7. Rachel is evaluating the risk of material noncompliance for her client. Part of this risk assessment process is determining if any of the risks identified are significant. What should Rachel do during her assessment?

    a. Her judgment should include the effects of identified controls related to the risk.

    b. If a significant risk is identified, Rachel should exclude control activities while obtaining an understanding of her client's controls.

    c. Rachel determines that a risk is significant and, therefore, applies special audit consideration.

    d. Rachel should not consider the nature of the risk when determining if special audit consideration is needed for an identified risk.

8. Which of the following is an example of a matter that frequently involves significant risk?

    a. Minor routine transactions.

    b. Transactions that require a minimal degree of manual intervention.

    c. Transactions that require little management intervention.

    d. Unusual transactions that by their nature make effective controls hard to implement.

9. Mark is an auditor conducting a single audit and is in the process of identifying programs and compliance requirements for testing. Which of the following actions should Mark take during these procedures?

    a. Mark should use the Compliance Supplement as a framework for determining applicable compliance requirements.

    b. Mark is responsible for identifying and understanding the client's government programs along with their compliance requirements.

    c. Mark should allow management to determine which government programs and compliance requirements to test.

    d. Mark can disregard the Compliance Supplement as a source for identifying compliance requirements if the federal programs being tested are not included in the Supplement.

10. Which of the items below accurately describes the role of selection and application of accounting policies during a single audit?

    a. Auditors are not allowed to help clients with the selection or application of accounting principles.

    b. Auditors should gain an understanding of the entity's selection and application of accounting policies and assess whether the policies are suitable.

    c. If the auditor assisted in the selection and application of the client's accounting principles, consideration of the accounting policies will still be a time-consuming activity.

    d. If the auditor was involved with the client's selection of accounting principles, he must still perform a thorough review of relevant accounting standards and prior year financial statements.

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.)**

5. Auditors need to determine whether AU-C 935 is applicable when performing an audit of state or local grant activity. This standard applies when the auditor is either engaged or required by law or regulation to perform a compliance audit in accordance with what requirements? **(Page 306)**

    a. Generally accepted auditing standards, *Government Auditing Standards,* and a governmental audit requirement requiring an opinion on compliance. [This answer is correct. AU-C 935, *Compliance Audits,* applies when an auditor is engaged or required to perform a compliance audit in accordance with all of these requirements.]

    b. Generally accepted accounting principles, *Government Auditing Standards,* and governmental requirements requiring compliance opinions. [This answer is incorrect. Generally accepted accounting principles are not one of the standards required to be met in a compliance audit under AU-C 935.]

    c. *Government Auditing Standards* and a governmental audit requirement requiring a compliance opinion. [This answer is incorrect. AU-C 935 applies when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with these two requirements. However, there is a third standard which is also required.]

    d. Generally accepted auditing standards, *Government Auditing Standards,* and the Internal Revenue Code. [This answer is incorrect. The Internal Revenue Code is not one of the standards required to be met in a compliance audit applicable to AU-C 935.]

6. Which of the following factors may influence the nature and extent of risk assessment procedures for an entity during a single audit? **(Page 309)**

    a. The level of personnel involved in the compliance-assurance process. [This answer is incorrect. The level of the entity's personnel involved in the compliance-assurance process (such as management or employee) is a factor that would help an auditor understand the possible financial statement effects of compliance requirements, but it would not influence the extent of risk assessment procedures.]

    b. The age and complexity of the applicable compliance requirements. [This answer is correct. According to the GAS/SA Audit Guide and AU-C 935, the nature and extent of the risk assessment procedures may vary for different entities and are influenced by factors such as the newness and complexity of the applicable compliance requirements.]

    c. The ways management addresses customer complaints. [This answer is incorrect. How the management of an entity addresses customer complaints does not necessarily influence risk assessment procedures. However, how management addresses audit findings would be a factor.]

    d. How likely it is noncompliance will occur. [This answer is incorrect. This is not a factor that may influence the nature and extent of risk assessment procedures, but rather it is a way for the auditor to understand the possible financial statement effects of compliance requirements.]

7. Rachel is evaluating the risk of material noncompliance for her client. Part of this risk assessment process is determining if any of the risks identified are significant. What should Rachel do during her assessment? **(Page 311)**

    a. Her judgment should include the effects of identified controls related to the risk. [This answer is incorrect. AU-C 315.28 and the GAS/SA Audit Guide indicate that as part of the risk assessment process, the auditor should determine whether any risks identified are significant risks. However, this judgment *excludes* the effects of identified controls related to the risk.]

b. If a significant risk is identified, Rachel should exclude control activities while obtaining an understanding of her client's controls. [This answer is incorrect. According to the GAS/SA Audit Guide, if a significant risk exists, the auditor should obtain an understanding of the entity's controls, *including* control activities, relevant to the risk.]

c. Rachel determines that a risk is significant and, therefore, applies special audit consideration. [This answer is correct. The AICPA Risk Assessment Audit Guide observes that with respect to the determination of significant risk that, in a situation in which the auditor assess inherent risk as high, moderate, or low, a significant risk would be one that is higher than high and, thus, requires special audit consideration.]

d. Rachel should not consider the nature of the risk when determining if special audit consideration is needed for an identified risk. [This answer is incorrect. The auditor determines whether the risk is such that it requires special audit consideration by focusing on several things such as the nature of the program, the likely magnitude of the potential misstatement or noncompliance, and the likelihood of misstatements or noncompliance occurring. However, the nature of the risk is particularly important.]

8. Which of the following is an example of a matter that frequently involves significant risk? **(Page 311)**

a. Minor routine transactions. [This answer is incorrect. Significant nonroutine transactions, such as transactions that are unusual due to their size or nature, can often be a matter of significant risks.]

b. Transactions that require a minimal degree of manual intervention. [This answer is incorrect. An example of a matter that can often involve significant risk is transactions requiring a large degree of manual intervention in data collection and processing.]

c. Transactions that require little management intervention. [This answer is incorrect. One of the examples of matters that may involve significant risks is transactions that involve a relatively large degree of management intervention in specifying the accounting treatment.]

d. Unusual transactions that by their nature make effective controls hard to implement. [This answer is correct. Unusual or infrequent transactions that by their nature make effective controls difficult to implement (such as major litigation) are examples of matters that frequently have significant risks.]

9. Mark is an auditor conducting a single audit and is in the process of identifying programs and compliance requirements for testing. Which of the following actions should Mark take during these procedures? **(Page 323)**

a. Mark should use the Compliance Supplement as a framework for determining applicable compliance requirements. [This answer is correct. AU-C 935 cites the OMB Compliance Supplement as a framework for determining applicable compliance requirements. In a Uniform Guidance compliance audit, the applicable compliance requirements are those that may have a direct and material effect on each major program.]

b. Mark is responsible for identifying and understanding the client's government programs along with their compliance requirements. [This answer is incorrect. AU-C 935.14 clarifies that management (not the auditor) is responsible for identifying an entity's government programs and understanding and complying with their compliance requirements.]

c. Mark should allow management to determine which government programs and compliance requirements to test. [This answer is incorrect. The auditor should determine which government programs and compliance requirements to test, not management.]

d. Mark can disregard the Compliance Supplement as a source for identifying compliance requirements if the federal programs being tested are not included in the Supplement. [This answer is incorrect. The GAS/SA Audit Guide explains that the Compliance Supplement is the primary source for identifying compliance requirements for federal programs. The Uniform Guidance states that the auditor must follow

the guidance in Part 7 of the Compliance Supplement for programs not included in the Compliance Supplement.]

10. Which of the items below accurately describes the role of selection and application of accounting policies during a single audit? **(Page 327)**

    a. Auditors are not allowed to help clients with the selection or application of accounting principles. [This answer is incorrect. For many entities, the auditor is instrumental in assisting with selection of accounting principles and the methods by which they are applied.]

    b. Auditors should gain an understanding of the entity's selection and application of accounting policies and assess whether the policies are suitable. [This answer is correct. AU-C 315.12 states that the auditor should obtain an understanding of the entity's selection and application of accounting policies and evaluate whether the policies are appropriate. Gaining this understanding is important for considering the risks of material misstatement and noncompliance.]

    c. If the auditor assisted in the selection and application of the client's accounting principles, consideration of the accounting policies will still be a time-consuming activity. [This answer is incorrect. If the auditor was instrumental in selecting the client's accounting principles and the application methods, then the consideration of accounting policies should ordinarily not be a time-consuming process since the auditor already possesses much of the requisite knowledge.]

    d. If the auditor was involved with the client's selection of accounting principles, he must still perform a thorough review of relevant accounting standards and prior year financial statements. [This answer is incorrect. If the auditor assisted with the selection and application of the client's accounting principles, he can generally confine inquiries of the client to matters such as the manner and consistency of application of such policies.]

PLANNING DECISIONS AND JUDGMENTS

The information the auditor obtains 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, (b) the risks of material noncompliance, (c) the overall audit strategy, and (d) the specific nature, timing, and extent of further audit procedures.

The GAS/SA Audit Guide, Paragraph 10.06, 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 of noncompliance.
- 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 and complexity of computer processing used to administer the program.
- Whether the *OMB Compliance Supplement* identifies the program as being higher risk.

Audit Risk of Noncompliance and Materiality Are Considered Together

AU-C 935 establishes requirements and provides guidance regarding consideration of audit risk of noncompliance in a single audit. According to the GAS/SA Audit Guide, Paragraph 6.25, audit risk of noncompliance and materiality need to be considered together for each major program being audited 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. Audit risk, including audit risk of noncompliance, is discussed later in this lesson.

Materiality

Determining Materiality for the Single Audit. AU-C 935.13 states that the auditor should determine and apply materiality levels based on the governmental audit requirement. The GAS/SA Audit Guide, Paragraph 6.49, states that in a compliance audit, materiality levels are used for the following purposes:

- Determining the nature and extent of risk assessment procedures.
- Identifying and assessing risks of material noncompliance.

- Determining the nature, timing, and extent of further audit procedures.
- Evaluating compliance with the direct and material compliance requirements.
- Reporting findings of noncompliance and other matters.

AU-C 935.A7 explains that the auditor's consideration of materiality is generally in relation to a federal award program taken as a whole. However, a governmental audit requirement may specify a different level of materiality for certain purposes. For example, the Uniform Guidance establishes a lower materiality threshold for reporting findings of noncompliance. It requires the auditor to report noncompliance that is material to the type of compliance requirement (e.g., allowable costs, program income, etc.). Paragraph 6.47 of the GAS/SA Audit Guide explains that, in a compliance audit, the auditor's judgment about matters that are material to users of the auditor's report is based on consideration of their needs as a group, including grantors.

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 program 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 Uniform Guidance audit of compliance 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 the Uniform Guidance, 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 2 CFR section 200.516(a).

In addition, materiality for auditing compliance under GAAS and the Yellow Book is determined at the financial statement level.

Paragraph 10.11 of the GAS/SA Audit Guide states that the auditor should apply the concept of materiality to each major program, not all major programs combined, when designing audit tests and when developing an opinion on compliance. 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 professional judgment in making this determination. Auditors should consider both quantitative and qualitative factors when determining whether a noncompliance item has a material effect. Paragraph 10.10 of the GAS/SA Audit Guide indicates that materiality in a Uniform Guidance audit 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.

Compliance requirement and audit finding materiality levels are lower levels of materiality than major program materiality. 2 CFR section 200.516(a) requires auditors to report material noncompliance with the federal statutes,

regulations, and terms and conditions of federal awards related to a major program in the schedule of findings and questioned costs. Paragraph 6.51 of the GAS/SA Audit Guide states that "the auditor's determination of whether an instance of noncompliance with federal statutes, regulations, and the terms and conditions of federal awards is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement identified in the *Compliance Supplement*." For example, if noncompliance relating to eligibility is discovered, the auditor first decides 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 Uniform Guidance 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.

Materiality for Purposes of Assessing Compliance with Compliance Requirements. The Uniform Guidance 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 considers materiality in relation to each compliance requirement and each major program being audited. 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.

For purposes of assessing compliance with laws and regulations, Paragraph 10.12 of the GAS/SA Audit Guide defines a "material instance of noncompliance" as:

> . . . a failure to comply with federal statutes, regulations, and the terms and conditions of the federal award 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 the Uniform Guidance 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 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. Noncompliance that is material to the particular type of compliance requirement for the major program and/or that meets the criteria in the Uniform Guidance for inclusion in the schedule of findings and questioned costs should also be reported.

***Government Auditing Standards* Requirements.** The Yellow Book, Paragraph 4.47, 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.

Planning Tests of Compliance. When planning tests of compliance, the materiality amount is one of the items that is used in making decisions about the nature, timing, and extent of procedures for individual federal award programs. The auditor frequently does not use a single source or single type of audit procedure to obtain sufficient appropriate audit evidence regarding each major program's compliance. Rather, the auditor's conclusions might be based on evidence obtained from several sources and by applying a variety of procedures, such as analytical procedures, sampling, testing individually important items, or testing 100% of a population.

It is important to note that program and compliance requirement materiality would not be the auditor's sole consideration in making a decision about the type of audit procedure to be applied. The consideration of materiality should be combined with a careful consideration of audit risk, including the risk of material noncompliance, and other types of audit procedures in order to design the most efficient and effective audit approach in the circumstances.

Assessing Risks of Material Misstatement

Audit risk in a financial statement audit is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. 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.

Responding to Risks at the Financial Statement Level. The auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. AU-C 330.A1 provides guidance to auditors when determining overall responses to address risks of material misstatement at the financial statement level. These responses may include:

- Emphasis to the audit team to use professional skepticism.
- Assigning staff with higher experience levels or specialized skills or using specialists.
- 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 a risk of management override of controls, AU-C 240.29 states that overall responses should include the auditor—

- Considering the knowledge, skill, and ability of individual engagement team members when assigning and supervising them.
- Evaluating the client's selection and application of accounting principles, especially in subjective areas.
- Incorporating 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, best practices suggest that auditors be as specific as possible when describing risks. A well articulated risk describes—

- The cause of the risk.
- The account balance, class of transactions, disclosure, or major program and how it may be affected (i.e., overstatement or understatement).
- If a fraud risk, the type of risk (misappropriation of assets or fraudulent financial reporting).
- The relevant assertion (or that it is an overall risk at the financial statements, schedule of expenditures of federal awards, or major program level).

Documentation. AU-C 315.33 requires the auditor to document the identified and assessed risks of material misstatement at the financial statement level. AU-C 330.30 requires the auditor to document the overall responses to address the assessed risks of material misstatement at the financial statement level. Thus, the auditor needs to include in audit documentation both the identified and assessed risks at the financial statement level and the overall responses to them. 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.

Assessing Risks of Material Noncompliance

In a single audit, the auditor is required to determine whether the recipient has complied with federal statutes, regulations, and the terms and conditions of federal awards 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 engagement team discussion held at the beginning of the audit should cover the susceptibility of the recipient's major programs to material noncompliance.

Audit Risk of Noncompliance. AU-C 935.11 defines the *audit risk of noncompliance* as "the risk that the auditor expresses an inappropriate audit opinion on the entity's compliance when material noncompliance exists." It is a function of the risk of material noncompliance and the detection risk of noncompliance. According to the GAS/SA Audit Guide, Paragraph 6.28, the components of audit risk in a Uniform Guidance audit of compliance are as follows:

- *Risk of Material Noncompliance.* The risk that material noncompliance exists prior to the audit. It consists of the following:
    - *Inherent Risk of Noncompliance.* The susceptibility of a major program's compliance requirements to noncompliance that could be material, either individually or when aggregated with other instances of noncompliance, before consideration of any related controls over compliance.
    - *Control Risk of Noncompliance.* The risk that noncompliance with a compliance requirement that could occur and that could be material to a major program, either individually or when aggregated with other instances of noncompliance, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control over compliance.
- *Detection Risk of Noncompliance.* The risk that the procedures performed by the auditor to reduce audit risk of noncompliance to an acceptably low level will not detect noncompliance that exists and that could be material, either individually or when aggregated, with other instances of noncompliance.

According to Paragraph 6.38 of the GAS/SA Audit Guide, the auditor may evaluate inherent risk of noncompliance and control risk of noncompliance either combined or individually when assessing the risks of material noncompliance. In assessing such risks, the auditor might consider several factors, including the following included in Paragraph 6.39 of the GAS/SA Audit Guide:

- The complexity of the direct and material compliance requirements, their susceptibility to noncompliance, and the length of time the entity has been subject to them.
- The auditor's observations about the entity's compliance with the direct and material compliance requirements in prior years.
- The potential effect on the entity of noncompliance with the direct and material compliance requirements.
- The amount of judgment needed to satisfy the compliance requirements.
- The auditor's assessment of the risks of material misstatement in the financial statement audit.

Detection Risk of Noncompliance. In determining an acceptable level of detection risk, the auditor considers the assessed inherent risk and control risk and the extent to which he or she wants to limit audit risk related to the major

program. As assessed inherent risk and control risk decrease, 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 and control risk.

Assessing the Risk of Material Noncompliance. The GAS/SA Audit Guide, Paragraph 6.40, 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.

Documentation of Audit Risk. The auditor should document the assessment of the risk of material noncompliance (i.e., the combined inherent and control risk) for purposes of determining the extent and nature of compliance testing for major programs. The auditor's assessment of inherent risk for compliance requirements applicable to major programs should also be documented. This information should be considered in developing an overall audit strategy and in establishing the scope of audit procedures. It is important to note that when a single system of internal controls exists (as is the case in most small entities), the documentation of significant information on the client's organization can be done once for financial audit purposes and does not have to be duplicated for single audit purposes.

Establishing an Overall Audit Strategy

AU-C 300.07 states that 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, includes the identification of overall risks, 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. Determination of audit strategy would normally be determined by more senior and experienced members of the audit team, including the audit partner, given the judgments that are required. An important factor in determining the audit strategy in a single audit is the requirement for the auditor to test compliance with federal statutes, regulations, and the terms and conditions of federal awards.

AU-C 300.08 provides that in establishing the overall audit strategy the auditor should do the following:

a. Determine the key characteristics of the engagement that define its scope.

b. Determine the reporting objectives of the engagement to plan the timing of the audit and the nature of communications required.

c. Consider the significant factors that will determine the focus of the audit team's efforts.

d. Consider the results of preliminary audit activities.

e. Consider, if applicable, the knowledge from other engagements performed for the entity.

f. Determine the nature, timing, and extent of resources needed to perform the audit.

Steps a. and b. 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. Steps d. and e. concern additional information that also may affect the focus of the engagement team's efforts. Finally, step f. concerns the personnel resources that will be necessary to accomplish audit objectives, including the need for the involvement of specialists and other experts.

The GAS/SA Audit Guide, Paragraph 10.32, explains that to develop an overall strategy for a compliance audit, the auditor needs to have sufficient knowledge to be able to "understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on compliance." It is also necessary for the auditor to obtain an understanding of any additional audit requirements that are supplemental to GAAS and *Government Auditing Standards*.

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 or noncompliance.
- Results of previous audits that involved tests of controls, including the nature of identified deficiencies and the action(s) taken to address them.
- Discussion of matters with firm personnel responsible for performing other engagements for the entity.
- Evidence of management's commitment to sound internal control and importance attached to internal control, including appropriate documentation.
- Volume of transactions.
- Significant changes in accounting standards.
- 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.
- Manner of emphasizing 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.
- Determination of whether the work of the internal audit function will be used to obtain audit evidence or whether internal auditors will be used to provide direct assistance.

In developing the overall audit strategy, the auditor incorporates 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.* Determination of the composition and deployment of the audit team (and if necessary, the engagement quality control reviewer), including the assignment of audit

work to team members, especially the assignment of appropriately experienced team members to areas identified as having higher risks of material misstatement or material noncompliance. Other considerations include the extent of involvement of professionals possessing specialized skills and, for areas with higher risk, the timing of personnel deployment and engagement budgeting.

- *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.

Timing of Further Audit Procedures. As part of the audit strategy, an auditor considers whether to apply any substantive procedures or tests of controls before the end of the financial statement period. In an initial engagement, it is not unusual for the auditor to be engaged at or after the fiscal year end. This eliminates the opportunity to even consider spreading work during the year by interim testing. In a continuing engagement, there are opportunities to spread work over the fiscal period. This may be very desirable if the auditor has several clients with identical fiscal year ends.

In testing transactions, the auditor normally selects transactions from the entire period under audit. If the auditor can obtain reasonably accurate estimates of the number and total dollar amount of the transactions for the fiscal period under audit, a portion of this work can be done at any convenient interim date. The remainder of the testing would be completed as part of period-end procedures.

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 sufficiency as audit evidence usually depends 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 needs to perform tests of controls to gather evidence for use in assessing control risk.

Before designing the audit plan, the auditor considers whether the client's computer system provides a clear audit trail. If the system does not provide a clear trail, the auditor may need to change the nature of planned audit procedures. The auditor also considers 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 component 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.

Revising the Initial Audit Strategy. It is not uncommon for auditors, after developing the initial audit strategy, to obtain information indicating that the audit strategy needs to be revised. AU-C 300.10 states that the auditor should update and modify the audit strategy as necessary throughout the engagement.

Communicating with Those Charged with Governance. The auditor may discuss elements of the overall audit strategy with those charged with governance. Both GAAS 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 needs to 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. AU-C 300.14 requires that the auditor document the overall audit strategy, the audit plan, any significant changes made to them during the audit, and the reasons. However, professional standards do not necessarily require that a separate audit strategy memorandum be prepared to document in one place all matters that affect the 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 federal awarding agencies, pass-through entities, federal or state auditors, or other oversight entities to aid in planning the audit. The GAS/SA Audit Guide, Paragraph 3.15, 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. One efficient approach to documenting the audit strategy and any changes to it is to prepare a brief memorandum at the conclusion of the previous audit, based on a review of audit documentation and highlighting issues identified in the audit just completed, and then update and change it 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.

CONSIDERATION OF FRAUD

AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, establishes standards and provides guidance on the auditor's responsibility to consider the risks of fraud and to design the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated. A general discussion of AU-C 240 is in *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Audits of Nonprofit Organizations*.

Applicability of AU-C 240 in an Audit of Federal Award Programs

AU-C 240 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. Those requirements are also applicable to a Uniform Guidance compliance audit.

The GAS/SA Audit Guide, Paragraph 6.41, states that 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. Such assessment should be carried on throughout the audit. 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 consideration of audit risk at the financial statement level and the account balance or transaction class levels were discussed earlier in this lesson. 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. The consideration of risk of noncompliance at the major program level for the audit of the federal awards in a single audit was also discussed earlier in this lesson. This section provides more specific

guidance on assessing the risk of material misstatement and noncompliance due to fraud when assessing audit risk.

Types of Misstatements Caused by Fraud

Fraud is a broad legal concept, but from an audit perspective is an intentional act that results in a material misstatement in financial statements that are the subject of an audit. The following three conditions 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, that enable management or other employees to commit fraud.
- *Attitude/Rationalization.* Management or other employees are able to justify the acceptability of committing fraud.

Two types of misstatements 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.

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 a special purpose framework).

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 a special purpose framework). 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.

Noncompliance Caused by Fraud

The auditor should specifically assess the risks of material noncompliance with a major program's compliance requirements occurring due to fraud (i.e., fraud risk). According to Paragraph 6.42 of the GAS/SA Audit Guide, the assessment of fraud risk in a single audit relates to fraudulent acts that might result in such noncompliance or in the misappropriation of federal funds.

Paragraph 6.43 of the GAS/SA Audit Guide provides the following examples of procedures that the auditor might consider performing for each major program when assessing fraud risk in a compliance audit:

- Gather information needed to assess whether fraud risk factors, individually or in combination, present a risk of material noncompliance with compliance requirements that could have a direct and material effect on a major program.
- Conduct a meeting of audit team members in which the risks of material noncompliance due to fraud are discussed.
- Document entity-wide programs and controls in place to prevent, detect, and deter fraud and whether those controls are suitably designed and have been implemented.

- Inquire of management (including grants managers), those charged with governance, the internal audit function, and others about (a) the risks of fraud related to major programs and (b) possible or actual noncompliance or abuses of programs and controls that have come to their attention.

Noncompliance resulting from fraud relates to intentional violations of laws (including federal statutes), regulations, and the provisions of contracts or grant agreements (including federal awards).

The Auditor's Responsibility for Fraud Detection

AU-C 240.05 explains that the auditor is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement whether caused by fraud or error. AU-C 240 requires 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.

AU-C 935 extends the auditor's responsibilities for fraud to the compliance requirement level. AU-C 935.17 states that the auditor should assess the risks of material noncompliance whether due to fraud or error for each applicable compliance requirement and consider whether any of those risks may affect compliance with many compliance requirements and, thus, be pervasive risks. The auditor should develop an overall response to pervasive risks.

Immaterial Misstatements Caused by Fraud. AU-C 200.07 observes that 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 as a whole are detected. AU-C 240.A3 also notes that the auditor is primarily concerned with fraud that causes a material misstatement of the financial statements. If immaterial misstatements arising from fraud are detected, however, the auditor has responsibilities for evaluating the effect on the audit and communicating these matters to an appropriate level of management and those charged with governance.

Many governments and nonprofit organizations may have the expectation that the auditor will detect all cases of fraud, whether or not there are material misstatements or noncompliance. 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

AU-C 240.12 indicates that the auditor should maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, regardless of the auditor's past experience with the honesty and integrity of management and those charged with governance. AU-C 240.13–.14 establishes the following requirements that relate to maintaining professional skepticism during the planning and performance of the audit:

- Unless there is a reason to believe otherwise, accept client records and documents as genuine. Investigate further if conditions indicate a document may not be authentic or its terms have been modified or not disclosed.

- If inconsistent, vague, implausible, or otherwise unsatisfactory responses are made to inquiries of management, those charged with governance, or others, investigate further.

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 is not willing to accept less than persuasive evidence based on a belief that management or key employees are honest.

The Auditor's Fraud Risk Assessment Process

AU-C 240.25 requires auditors to assess identified risks of material misstatement due to fraud. AU-C 240.26 states that, based on a presumption that risks of fraud exist in revenue recognition, the auditor should evaluate which types of revenue, revenue transactions, or assertions give rise to such risks. Because federal awards to governmental and not-for-profit entities often have significant restrictions, the auditor might inquire of management or in-house legal counsel about federal awards, including their knowledge of any unusual or modified award 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.

Federal awards typically have significant restrictions. If the auditor becomes aware the client must comply with those restrictions or potentially repay the award, 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 award 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.

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 need to consider in identifying fraud risks includes the discussion among engagement team members, information from client acceptance and continuance procedures, the auditor's inherent risk of noncompliance assessment and, if applicable, other engagements performed for the entity.

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. Certain overall responses, such as the consideration of staffing and supervision, scrutiny of the selection and application of accounting principles, and incorporating an element of unpredictability in audit procedures, are considered in every audit and are incorporated into the audit programs in *PPC's Guide to Single Audits*.

AU-C 935.18 requires an overall response to pervasive risks of material noncompliance. AU-C 935.19 also requires the auditor to design and perform further audit procedures, including tests of details (which may include tests of transactions), to test compliance with each of the applicable compliance requirements in response to the assessed risks of material noncompliance. Risk assessment procedures, tests of controls, and analytical procedures alone are not considered sufficient to address a risk of material noncompliance.

Documenting the Fraud Risk Assessment. The auditor should document evidence that he or she assessed the risks of material misstatement and noncompliance due to fraud. The auditor is required to document the following:

- Engagement team discussion on susceptibility of financial statements to material misstatement due to fraud:
  - Significant decisions reached.
  - How and when it occurred and who participated.
- Identified and assessed risks of material misstatement due to fraud:
  - At the financial statement level.

- At the assertion level.

- Responses to the assessed risks of material misstatement due to fraud:
  - Overall responses at the financial statement level.
  - Specific responses at the assertion level (nature, timing, and extent of audit procedures and linkage to assessed risks).
  - Results of audit procedures, including those that address risk of management override.
- Communications about fraud to management, those charged with governance, and others.
- How the auditor overcame the presumption that improper revenue recognition is a fraud risk, if applicable.

This course describes a practical approach to fraud risk assessment that addresses the requirements in AU-C 240. Exhibit 1-3 illustrates how this approach accomplishes the requirements of AU-C 240. The auditor's fraud risk assessment process should be documented. One option is to use the practice aids provided in *PPC's Guide to Single Audits*.

Exhibit 1-3

Fraud Risk Assessment

AU-C 240 Requirements	PPC Approach to Fraud Risk Assessment
Hold a discussion among engagement team members to consider the susceptibility of the client's financial statements and federal award programs to material misstatement or noncompliance due to fraud and to reinforce the importance of professional skepticism. Obtain other information needed to identify risks of material misstatement and noncompliance due to fraud.	**Step 1.** Gather information about the entity and its environment that may be relevant in identifying risks of material misstatement and noncompliance due to fraud: • Discussion among engagement team members. • Inquiries of management and others. • Considering whether fraud risk factors are present. • Preliminary analytical procedures. • Other procedures.
Identify risks that may result in material misstatements or noncompliance due to fraud.	**Step 2.** Identify risks that could result in material misstatements or noncompliance due to fraud.

AU-C 240 Requirements	PPC Approach to Fraud Risk Assessment
Assess the identified risks after taking into account an evaluation of the entity's antifraud programs and internal controls.	**Step 3.** Assess the identified risks: • Evaluate programs and controls. • Assess fraud risks.
Respond to the results of the risk assessment.	**Step 4.** Develop appropriate responses to risks of material misstatements or noncompliance due to fraud: • Overall responses. • Specific responses. • Responses to further address the risk of management override of controls.

* * *

Communication Requirements

Generally Accepted Auditing Standards. Auditors are responsible for following the requirements of AU-C 240 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), the auditor is required 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. AU-C 240.A69 indicates that auditors may consider it appropriate to communicate with those charged with governance regarding communication about those misappropriations committed by lower-level employees that do not result in a material misstatement. Auditors also normally reach an understanding with those charged with governance regarding communication about those misappropriations committed by lower level employees. In the absence of such an agreement, it is a best practice for the auditor to report all instances of fraud to both the appropriate level of management and to those charged with governance. It is a good idea that communications about possible fraud be made in writing; if made orally, the nature of the communication should be documented in the workpapers.

In some cases, the auditor may have a duty to disclose fraud or violations of laws or regulations to outside parties. Examples of those situations include:

- To comply with legal or regulatory requirements.
- To a successor auditor making inquiries in accordance with AU-C 210, *Terms of Engagement*.
- 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 a best practice for the auditor to 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. The absence of or deficiencies in processes and controls designed to mitigate or otherwise prevent, deter, and detect fraud may also be matters that require communication.

***Government Auditing Standards*.** Under both GAAS and the Yellow Book, auditors are required to determine whether those charged with governance are adequately informed about fraud and noncompliance with laws and

regulations that have a more than inconsequential effect on the financial statements. The Yellow Book expands this to include abuse and noncompliance with provisions of contracts and grant agreements. The Book indicates auditors should provide written communication about findings of abuse or noncompliance with contracts or grant agreements with a financial statement effect that is more than inconsequential. The Yellow Book requires the auditor to provide written communication about findings of noncompliance or abuse "that are less than material but warrant the attention of those charged with governance." The Yellow Book leaves to the auditor's judgment whether and how to communicate findings that are inconsequential or do not warrant the attention of those charged with governance. These can be communicated in a management letter.

Under certain circumstances, auditors are required to report to those charged with governance when management fails to respond appropriately to the auditor's findings of known or likely fraud, noncompliance, or abuse. The auditor may also be required to report the matters directly to outside parties. The Yellow Book indicates auditors should report directly to those charged with governance:

- Management's failure to report findings of fraud, noncompliance, or abuse to external parties when required to do so by laws or regulations.

- Management's failure to respond in a timely and appropriate manner when findings of fraud, noncompliance, or abuse are likely to have a material effect on the financial statements and involve funds received from another government agency.

As discussed in the previous paragraph, in certain circumstances, the auditor is required to communicate to those charged with governance management's failure to respond appropriately to findings of fraud, noncompliance, or abuse. If, after the auditor's communication with those charged with governance, the entity's response is still inadequate, the auditor should communicate directly with outside parties as follows:

- The auditor should report relevant information directly to external parties if (a) the auditor has communicated to those charged with governance that management has not met legal or regulatory requirements to report fraud, noncompliance, or abuse to specific external parties and (b) the entity does not report the findings as soon as practicable after this communication.

- The auditor should report relevant information directly to the funding agency if (a) the auditor has communicated to those charged with governance that management failed to take timely, appropriate actions to respond to findings of fraud, noncompliance, or abuse that involves funding from another government agency and is likely to be material to the financial statements and (b) the entity does not take appropriate steps as soon as practicable after this communication.

In both of these situations, the auditor should obtain sufficient appropriate audit evidence (for example, by confirmation with outside parties) to corroborate management's assertion that it has reported such findings in accordance with laws, regulations, and funding agreements. If unable to do so, the auditor should report the findings. The above reporting requirements are in addition to any other legal requirements to report such findings directly to outside parties and are applicable even if the auditor has resigned or been dismissed from the audit.

The auditor may also be required by laws, regulations, or policies to report indications of fraud, abuse, or noncompliance to authorities before performing additional audit procedures. Paragraph 4.09 of the Yellow Book requires auditors to evaluate the impact on their audit if investigations or legal proceedings have been initiated or are in progress. It may be necessary to withdraw from the engagement or to defer work in order to avoid interfering with investigations.

OVERALL ASPECTS OF AUDIT PROGRAMS AND AUDIT DOCUMENTATION REQUIREMENTS

Overall Aspects of Audit Programs

In planning an audit, the auditor develops an audit plan documenting the audit procedures to be used that, when performed, are expected to reduce audit risk to an acceptably low level. AU-C 300.A14 explains that the audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

AU-C 300.09 indicates that the auditor should develop an audit plan that includes a description of the following:

a. The nature and extent of planned risk assessment procedures.

b. The nature, timing, and extent of planned further procedures at the relevant assertion level.

c. Other planned procedures required by GAAS.

AU-C 300.10 notes that the auditor should update and change the audit plan as needed during the audit.

The audit strategy was discussed earlier in this lesson. As part of developing the overall audit strategy was discussed earlier in this lesson, the auditor will ordinarily have identified programs, organizational units, account balances, and audit areas where there may be higher risks of material misstatement or noncompliance. 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. The auditor assesses risks of material misstatement or material noncompliance at the *relevant assertion* level and designs audit procedures to mitigate that assessed risk. For a financial statement audit, AU-C 315.04 defines a relevant assertion as one "that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated." In a single audit, the auditor should also design and perform substantive procedures for 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. AU-C 315.05 explains that the auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at both the financial statement and relevant assertion levels. Risk assessment procedures alone do not provide sufficient appropriate audit evidence on which to base an opinion. In all circumstances, further audit procedures are necessary to support an opinion.

Obtaining an understanding of the entity and its environment, including its internal control, is an essential aspect of the consideration of risk. Thus, audit procedures performed to obtain that understanding are referred to as *risk assessment procedures* because the information obtained by performing those procedures is used to support the auditor's assessment of the risk of material misstatement. Auditors normally consider the effectiveness of various types of risk assessment procedures in identifying risks during the planning process. A variety of risk assessment procedures are used when obtaining an understanding of the entity and its environment. For example, an auditor cannot limit his or her risk assessment procedures to inquiry alone.

In addition to providing information about the entity and its environment, including its internal control, the performance of risk assessment procedures may provide audit evidence about relevant assertions related to account balances, transaction classes, or disclosures, or about the operating effectiveness of controls. Therefore, risk assessment procedures may also serve as tests of controls or substantive procedures, or may be performed concurrently with those procedures. However, 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 GAS/SA Audit Guide, Paragraph 10.37, explains that in a compliance audit, the auditor must perform tests of transactions and such other auditing procedures necessary to provide the auditor with sufficient appropriate audit evidence to support an opinion on compliance for each major program. This requires designing procedures to detect both intentional and unintentional noncompliance. It is important to remember that procedures that are effective for detecting unintentional noncompliance may not be effective for detecting noncompliance that is intentional and concealed through collusion between the auditee's personnel and a third party or among the management or other employees of the entity.

The Compliance Supplement 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.

Documentation Requirements

AU-C 330.30 requires the auditor to document the following related to preparing the detailed audit plan:

- Overall responses to the assessed risks of material misstatement at the financial statement level.
- Nature, timing, and extent of further audit procedures performed.
- Linkage of the procedures performed with the assessed risks at the relevant assertion level.
- Results of the audit procedures performed, and conclusions that are not otherwise clear.

AU-C 300.09 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 planned 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).

Planning for audit procedures takes place during the course of the audit and the risk assessment procedures may cause a change in planned specific further audit procedures. AU-C 300.10 notes that the auditor should document changes to the original audit plan.

AU-C 935 establishes specific documentation requirements for compliance audits. AU-C 935.39–.42 states that the auditor should document the following:

- The risk assessment procedures performed, including procedures to obtain an understanding of internal control over compliance.
- The auditor's responses to the assessed risks of material noncompliance, procedures performed to test compliance with the applicable compliance requirements, and the results of those procedures, including any tests of controls over compliance.
- Materiality levels and the basis on which they were determined.
- How the auditor complied with specific governmental audit requirements in addition to the requirements of GAAS and *Government Auditing Standards*.

Both AICPA standards and *Government Auditing Standards* establish audit documentation requirements that need to 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 nature, timing, and extent of the audit procedures performed to comply with professional standards and other applicable legal or regulatory requirements,
- the results of the audit procedures performed and the audit evidence obtained, and
- the significant judgments made and conclusions reached on significant findings or issues.

AU-C 230 also provides certain specific audit documentation requirements as follows:

a. *Departures from the Requirements in the Auditing Standards.* In the rare instances in which an auditor deems it necessary to depart from a presumptively mandatory requirement of the auditing standards, documentation *must* be made of the justification for the departure and how alternative procedures performed were sufficient to achieve the objectives of the requirement (AU-C 230.13). AU-C 230.A22 states that this requirement is mandatory unless the related presumptively mandatory requirement is:
    - Not relevant, for example, if the requirement relates to service organizations and the client does not use a service organization.
    - Conditional, for example, if the requirement is to document the expectation if not readily determinable when performing substantive analytical procedures and the expectation is readily determinable.

b. *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.

c. *Identification of Items Tested.* Documentation of procedures performed should identify the items tested.

d. *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 and extent of the review.

e. *Significant Findings or Issues.* Auditors are required to document information related to significant audit findings or issues.

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 (see the discussion later in this lesson).
- Subsequent discovery of facts that existed at the date of the report (see the discussion later in this lesson).
- Other reasons an auditor considers it necessary to make an addition or change to the workpapers after the documentation completion date (see the discussion later in this lesson).

g. *Report Release Date.* The report release date should be recorded in the audit documentation.

In addition to the requirements discussed above, the Yellow Book, at Paragraph 4.15, states that auditors should document supervisory review of the evidence that supports the auditor's report before the audit report is issued; that is, before the report release date.

GAAS expands the auditor's documentation requirements and provides guidance on revisions to audit documentation made after the date of the auditor's report. The final assembly and completion of the audit file should occur within 60 days of the report release date. After that date, the auditor should not delete or discard any documentation prior to the required five-year retention period discussed below. Additions to documentation after that date should indicate when and by whom the change was made and reviewed; the specific reasons for the change; and the procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report.

***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. The Yellow Book states that auditors should make appropriate individuals, as well as audit documentation, available in a timely manner when requested by 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. SQCS No. 8 (QC 10.51 and QC 10.A60) and AU-C 230.17 specifically indicate that this period should not be shorter than five years from the report release date. This is a longer retention period than established by the Uniform Guidance for a single audit. However, statutes, regulations, or the firm's quality control policies may prescribe a longer period. Auditors should follow such requirements that mandate a longer retention period.

The Uniform Guidance, at 2 CFR section 200.517, states that the auditor must retain audit documentation for at least three years after the date of issuance of the auditor's report(s) to the auditee. (However, that period is extended to at least five years by AU-C 230.A27.) The cognizant agency for audit, oversight agency for audit, cognizant agency for indirect costs, or pass-through entity could require the auditor to maintain the workpapers for a longer 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 audit documentation or reports are destroyed.

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 SQCS No. 8 (QC 10.A56), such controls may:

- Enable clear identification of when and by whom documentation was created, changed, or reviewed.
- Protect 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 Yellow Book, at Paragraph 3.92, states that auditors should establish policies and procedures for the safe custody and retention of audit documentation for a time that is sufficient to satisfy legal, regulatory, and administrative requirements. The Yellow Book further states that auditors should establish information systems controls related to accessing and updating the audit documentation that is stored electronically.

It is best practice 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., fieldwork still in progress, after fieldwork 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. A Technical Question and Answer (Q&A 8345.02) addresses the destruction of audit documentation by fire, flood, or natural disaster. The guidance also could apply if workpapers are lost, deleted, or damaged due to other circumstances. The Q&A 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 needs to consider whether he or she will be able to demonstrate that sufficient audit evidence has been obtained to afford a reasonable basis for expressing an opinion on the financial statements. Except for very small engagements, it is unlikely that the auditor will be able to recreate sufficient documentation without reperforming at least some of the procedures.

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 needs to strive to prepare audit documentation as the audit progresses to avoid inadvertently omitting critical information or incorrectly recording aspects of the completed procedures 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 audit report date represents the date that the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. The same concept applies to dating the auditor's report on the schedule of expenditures of federal awards, and the report on compliance with requirements applicable to major federal programs. According to AU-C 700.41, such 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.

AU-C 220.19 requires that, by the date of the audit report, the engagement partner be satisfied that sufficient appropriate evidence has been obtained to support audit conclusions and the audit report to be issued, by discussion with the engagement team and a review of audit documentation. This requirement seems to imply that detailed and supervisory reviews need to be completed before the engagement partner's review. AU-C 220.A15

observes that the engagement partner may review all audit documentation, but need not do so. AU-C 230.09c requires documentation of who reviewed the audit work and the review's date and extent.

According to AU-C 580.A27, the auditor does not need to be in physical receipt of the management representation letter on the date of the auditor's report, but needs to 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 the auditor gives the client permission to use the auditor's reports. For most audits, this will be the date the auditor delivers the report to the client. AU-C 230.15 requires the auditor to document the report release date in the workpapers. In most cases, the report release date will be close to the date of the auditor's reports. If there are significant delays in releasing the reports, auditors need to consider whether to apply subsequent events procedures. A delay in releasing the report of more than two weeks after the report date may result in extending the subsequent events review to the later date and redating the report. This matter may be covered in the firm's quality control policies and procedures.

Documentation Completion Date. Quality control standards specify that firms should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been released. Those policies and procedures need to 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. Professional standards require workpapers to be completed on a timely basis (AU-C 230.07). In addition, the final assembly and completion of the audit file should occur within 60 days of the report release date. AU-C 230.06 refers to the date that workpapers should be assembled for retention as the *documentation completion date*. After that date, the auditor should 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 system of quality control. In addition, the auditor needs to consider whether there are regulatory or state requirements that specify a shorter documentation completion period.

While AU-C 230 does not specifically require the auditor to document the documentation completion date, as a practical matter, documentation of that date will ensure compliance with the requirement to complete final assembly of the workpapers within 60 days of the report release date.

Assembling and Completing the Audit File. AU-C 230.A26 indicates that at any time prior to the documentation completion date, the auditor is permitted to make changes to the workpapers that are administrative in nature, such as 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 reports, 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 reports such as replacing faxed copies of confirmations with originals.
- Perform routine file assembly procedures, which 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 changes to the workpapers after the date of the auditor's reports and prior to the documentation completion date constitute those that are part of the "wrap-up" or workpaper filing process. 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.

Making Changes to the Workpapers. AU-C 230.14 provides requirements for audit documentation when the auditor determines it is necessary to make additions or other changes to the audit workpapers after the date of the

auditor's reports other than those activities noted in the previous paragraph. Such changes may relate to the following:

a. *Omitted Procedures That Would Have Been Considered Necessary at the Time of the Audit.* In such cases, auditors should follow the guidance provided by AU-C 585, *Consideration of Omitted Procedures After the Report Date*.

b. *Subsequent Discovery of Facts That Existed at the Date of the Report.* For situations in which the auditor subsequently becomes aware of information that existed at the date of the reports but was not previously known to the auditor, the provisions of AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, should be followed.

For those changes noted in the previous paragraph, the auditor should make changes to the audit documentation to record the performance of the new procedure or the new conclusions that were reached. The documentation of the changes should include:

- When and by whom the changes were made and reviewed.
- The specific reasons for the change.
- The procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report.

The auditor needs to also consider whether there are regulatory or state requirements that differ from GAAS, such as Yellow Book requirements or those of a state agency that provides grant funding.

There might be other reasons why an auditor considers it necessary to make an addition or change to the workpapers after the documentation completion date. AU-C 230.A28 notes that an example of a circumstance in which the auditor may find it necessary to modify existing documentation or add new documentation after the documentation completion date is the need to clarify existing audit documentation arising from comments received during monitoring inspections. If the auditor deems that additions or amendments are necessary for a particular reason, the auditor should carefully consider the impact on the conclusions previously reached at the date of the auditor's report and the opinion expressed in the report. According to AU-C 230.18, in those situations, the auditor should document—

a. The specific reasons for the change.

b. When and by whom the changes were made and reviewed.

PART OF AUDIT PERFORMED BY OTHER AUDITORS

Reasons for Use of Other Auditors

Use of Small, Minority-owned, or Women-owned Firms. The Uniform Guidance, at 2 CFR section 200.509(a), 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" when procuring audit services. This requirement is often met by involving a small, minority-owned, or women-owned firm in a portion of the single audit engagement.

Use of Third-party Service Providers. Audit firms frequently subcontract portions of their audit work to other firms or to individual auditors. Third-party service providers are 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 but who assist in providing professional services. Independent contractors used by a CPA meet the definition of third-party service providers.

ET 1.150.040 requires that clients be informed, preferably in writing, if the audit firm will outsource professional services to a third-party service provider. If the audit firm intends to use a third-party service provider to perform

portions of the audit, the client should be informed before confidential information is shared with the service provider. If the client objects, the auditor should perform the services without using the third party or should decline the engagement. ET 1.150.040 applies when another party is used, for example, to audit an element, account, or item of the financial statements or to act as a specialist. The ruling does not seem to apply when another audit firm performs a separate engagement, the results of which will be used by the auditor; for example, when another firm audits a government's component unit. In addition, the client is not required to be informed when a third party is used only for administrative support services to the auditor, such as record storage or software application hosting. ET 1.700.040 requires a contractual agreement between the audit firm and the service provider to maintain the confidentiality of client information. This rule also requires members to be reasonably assured that the service provider has procedures in place to prevent the unauthorized release of confidential information.

Use of Component Auditors. Another situation that involves the use of other auditors is the separation of the engagement between the auditor of group financial statements and the auditor of a component of the group financial statements. AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors*), addresses special considerations that apply to group audits. The GAS/SA Audit Guide, Paragraph 6.58, indicates that AU-C 600 is not directly applicable to a Uniform Guidance compliance audit. Accordingly, the following paragraphs provide a high level overview of AU-C 600. In-depth guidance on group audits is provided in *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Audits of Nonprofit Organizations*.

Group Audit Considerations in a Uniform Guidance Compliance Audit

AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors*), addresses special considerations that apply to group audits of financial statements that include the financial information of more than one component (that is, *group financial statements*). AU-C 600 expands previous guidance related to using the work of other auditors to encompass audits of group financial statements.

A *component* may be an entity or business activity for which group or component management prepares financial information that is required to be included in group financial statements; for example, a component might be a subsidiary, division, geographical location, investment, product or service, function, process, or component unit of a government. Furthermore, *group financial statements* include the financial information of more than one component. This concept is broader than that of consolidated or combined financial statements because it encompasses not only separate entities, but also business activities.

The GAS/SA Audit Guide, Paragraph 6.57, explains that AU-C 600 "is, in part, intended to address the audit risk that results from the aggregation of component financial information (referred to here as *aggregation risk*)." The GAS/SA Audit Guide, Paragraph 6.58, further explains:

> The concept of aggregation risk in AU-C section 600 is not directly applicable to Uniform Guidance compliance audits because each major program is being opined on separately. Unlike a financial statement audit, there is no entity-wide opinion on compliance in a Uniform Guidance compliance audit. Additionally, even when a major program is administered by multiple organizational units, locations, or branches within a major program because the focus of the Uniform Guidance compliance audit is attribute based (that is, there is either compliance or noncompliance), the concepts of aggregation risk and component materiality as contemplated in AU-C section 600 would not be relevant. Instead, the auditor may have additional sampling considerations in such situations. . . Therefore, as a result of the unique nature of a Uniform Guidance compliance audit, the concept of a component in AU-C section 600 generally should only be applied when other auditors have been separately engaged to perform a portion of a Uniform Guidance compliance audit. In those cases, the auditor should follow the guidance in AU-C section 600 as it relates to other auditors (that is, component auditors), including considerations of whether to make reference to the other auditors in the auditor's report on compliance and on internal control over compliance.

Entities that receive federal awards may engage accounting firms on a joint venture or subcontract basis due to requirements to make positive efforts to use small businesses, minority-owned firms, or women-owned business enterprises. The GAS/SA Audit Guide, Paragraph 6.59, indicates that in these circumstances, it is usually not

appropriate to make reference to the other auditors. In the case of a joint audit, each of the auditors participating in the audit will sign the audit reports. The guidance in AU-C 600 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 signer of the report. In the case of a subcontract relationship, the subcontracting auditor often does not issue a separate report. Therefore, without a separate report, it would also not be appropriate to make reference to the subcontracting auditor.

Use of Internal Auditors

When the entity has an internal audit function, the external auditor may need to consider the nature of that function, including the extent to which internal auditors monitor internal control and compliance with compliance requirements that affect major programs. The work of internal auditors could affect the nature, timing, and extent of the external auditor's procedures to (a) obtain an understanding of the entity and its environment, including internal control over compliance, (b) assess risk, and (c) respond to the assessed risk. AU-C 610, *Using the Work of Internal Auditors*, addresses the external auditor's responsibilities when the entity has an internal audit function.

Because internal audit is an aspect of an entity's internal control, the external auditor should obtain an understanding of it as part of the overall understanding of the entity and its environment and identification and assessment of the risk of material misstatement. The understanding should include internal audit activities that are relevant to the compliance requirements and to planning the compliance audit.

After obtaining an understanding of the internal audit function, the external auditor may be able to use internal auditors to reduce work on the audit. Internal auditors may be used in the following ways:

a. *Use of the Work of Internal Audit.* The external auditor may be able to use the regular work performed by the internal auditors during the period to—

   (1) assist in obtaining an understanding of internal control (such as by obtaining documentation relating to internal control and responding to the auditor's inquiries); and

   (2) modify the nature, timing, or extent of further audit procedures (i.e., tests of controls or substantive procedures).

b. *Direct Assistance.* The external auditor may use internal auditors to perform certain procedures (such as performing tests of controls or substantive tests) under the external auditor's direction, supervision, and review.

When deciding how internal auditors will be used, the external auditor considers both the risks of material noncompliance and the amount of subjectivity needed to evaluate audit evidence supporting compliance with direct and material compliance requirements. It becomes more important for the external auditor to perform the tests as the risk of material noncompliance or the amount of subjectivity increases. It is important to note that, while the use of internal auditors or their work might affect the auditor's procedures, the external auditor is solely responsible for performing procedures to obtain sufficient appropriate audit evidence to support the auditor's report. The external auditor should make all significant judgments in the audit engagement. In addition, the external auditor normally performs his or her own tests for audit areas or assertions in which either the risk of material misstatement or noncompliance or the degree of subjectivity involved is high or for areas where there is a significant risk.

Using the Work of Internal Auditors. AU-C 610 indicates that external auditors can use the internal auditors' work performed during the period to reduce the work needed for the financial statement audit. The following are examples of how that work can be used:

a. *Understanding of Internal Control.* Internal auditors often prepare their own documentation of internal control, and the external auditor may be able to use that documentation in lieu of preparing checklists.

b. *Modifying the Nature, Extent, and Timing of Further Audit Procedures.* The internal auditor's work may provide sufficient evidence that will allow the external auditor to modify the nature, extent, and/or timing of tests of controls (when assessing control risk at either a moderate or low level) or substantive procedures.

The external auditor should assess the objectivity and competence of the internal auditors before using their work. The assessment is based on information obtained from prior experience with the internal auditors, discussions with management, and other sources. The external auditor should also determine if the internal audit function applies a systematic and disciplined approach to planning, performing, supervising, reviewing, and documenting its activities. If it is determined that the internal audit function lacks sufficient competence and objectivity, or lacks a systematic and disciplined approach to its activities the external auditor should not use their work.

When using the work of the internal auditor, the external auditor has a responsibility to test the work of the internal auditor. Tests should include reperformance of some procedures performed by the internal auditor. In addition, the external auditor may examine similar items and observe the internal auditor's procedures. Such procedures may include testing some of the internal auditors' work relating to each direct and material compliance requirement, by either (a) examining some of the controls, transactions, or balances examined or compliance requirements tested by the internal auditor or (b) examining similar controls, transactions, or balances or testing compliance requirements not examined or tested by the internal auditor. The results of the auditor's tests should be compared with the results of the internal auditors' work. The auditor also should read internal audit reports related to the work that is planned to be used.

The GAS/SA Audit Guide, Paragraph 6.66, identifies factors that affect the extent of the external auditor's testing of the internal audit function's work needed to support a decision to use its work in a compliance audit. Those following factors increase the amount of procedures the external auditor would have to perform on the internal audit function's work:

- The more judgment that is involved.
- The higher the assessed risk of material noncompliance.
- The less the internal audit function's organization status and relevant policies and procedures adequately support the internal auditors' objectivity.
- The lower the level of competence of the internal audit function.

When using the work of internal auditors, the following should be included in the audit documentation:

- The results of the evaluation of internal audit's status and policies and procedures to support the objectivity of the internal auditors, the level of competence of internal audit, and the application by internal audit of a systematic and disciplined approach, including quality control.
- The nature and extent of the work used and the basis for that decision.
- The procedures performed by the external auditor to evaluate the adequacy of the work used.
- The evaluation, in the aggregate, whether the use of the work of internal auditors in obtaining audit evidence, together with any use of internal auditors to provide direct assistance, results in the external auditor being sufficiently involved in the audit.

Using Internal Auditors to Provide Direct Assistance. Internal auditors may, under the auditor's direction, supervision, and review, be used to perform audit procedures that would have been performed by the external auditor. For example, internal auditors might assist the auditor in obtaining an understanding of internal control over compliance, testing controls, or testing compliance. Before using internal auditors to provide direct assistance, external auditors should assess the objectivity and competence of each internal auditor they want to use for direct assistance. If it is determined that an internal auditor lacks sufficient competence and objectivity to perform the proposed work, the external auditor should not use that internal auditor to provide direct assistance.

The external auditor should supervise, review, evaluate, and test the internal auditors' work to the extent considered necessary and also needs to:

- Inform the internal auditors about matters relevant to their procedures (such as their responsibilities, objectives of their tests, and possible compliance or auditing issues).

- Explain that all significant compliance and auditing issues they identify should be brought to the external auditor's attention.
- Test some of the internal auditors' work by reperforming some of their procedures.
- Be alert for any indications that the initial assessments about the internal auditors' competence and objectivity are no longer appropriate.

When using internal auditors to provide direct assistance, the following should be included in the audit documentation:

- The evaluation of the existence and significance of threats to objectivity, any safeguards that reduce or eliminate those threats, and the level of competence of the internal auditors used to provide direct assistance.
- The basis for the decision regarding the nature and extent of the work performed by the internal auditors.
- The nature and extent of the external auditor's review of the internal auditors' work, including documentation of the external auditor's testing of some of that work.
- The workpapers prepared by the internal auditors.
- The evaluation, in the aggregate, whether the use of the work of internal auditors in obtaining audit evidence, together with any use of them to provide direct assistance, results in the external auditor being sufficiently involved in the audit.

Communication With Those Charged With Governance. When the auditor plans to use internal auditors, the auditor should communicate that plan to those charged with governance. In addition, if the auditor plans to use the internal audit function to provide direct assistance, the auditor should obtain written acknowledgment from management or those charged with governance that the internal auditors will be allowed to follow the auditor's instructions and that the entity will not intervene in the work. The engagement letter can be used to make those communications.

Use of Federal Auditors

The Uniform Guidance, at 2 CFR section 200.509(c), allows federal auditors who comply with the requirements of the Uniform Guidance to perform all or part of the audit. 2 CFR section 200.7 defines *auditor* as follows:

> . . . an auditor who is a public accountant or a Federal, state, or local government or Indian tribe audit organization, which meets the general standards for external auditors specified in generally accepted government auditing standards (GAGAS). The term auditor does not include internal auditors of nonprofit organizations.

When participating in an audit with federal or other auditors, the auditor may want to consult with state, local, Indian tribe, 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 auditor's auditing and reporting needs. In order to maximize efficiencies, this communication ought to be made during the planning stages of the engagement.

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 the Uniform Guidance. For example, these reports may include special reports prepared in accordance with AU-C 806*, Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements*, 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 needs to be sure that he or she understands the auditing and reporting responsibilities and ought to 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. The Yellow Book independence standards also include provisions relating to internal auditors.

CLIENT RESPONSIBILITIES IN PLANNING A SINGLE AUDIT

To maximize efficiency in planning the single audit, the auditor ought to enlist the assistance of the client in gathering information needed to the plan and perform the audit. The degree of assistance the client will be able to provide depends on the qualifications of client personnel. However, a great number of tasks can be performed by clerical personnel, which could help reduce audit staff hours.

AU-C 935.08 expands the auditee's responsibilities to encompass compliance requirements. It indicates that auditee management is responsible for the following:

- Identifying the entity's government programs and understanding and complying with their compliance requirements.
- Establishing and maintaining effective controls that provide reasonable assurance government programs are administered in compliance with the compliance requirements.
- Evaluating and monitoring compliance with the compliance requirements.
- Taking corrective actions when noncompliance is identified.

The GAS/SA Audit Guide, Paragraph 5.35, further clarifies these responsibilities for a Uniform Guidance audit. It lists the following management responsibilities:

- Identifying in its accounts all federal awards received and expended and the federal programs under which they were received. This should include, as applicable, the CFDA title and number, federal award identification number and year, name of the federal agency, and name of the pass-through entity (if any).
- Complying with federal statutes, regulations, and the terms and conditions of federal awards.
- Establishing and maintaining effective internal control over federal awards that provides reasonable assurance that the entity is managing federal awards in compliance with federal statutes, regulations, and the terms and conditions of federal awards.
- Procuring or otherwise arranging for the audit required under the Uniform Guidance and ensuring it is properly performed and submitted when due.
- Evaluating and monitoring noncompliance with federal statutes, regulations, and the terms and conditions of federal awards.
- Taking prompt action when noncompliance is identified, including noncompliance identified in audit findings.
- Promptly following up and taking corrective action on audit findings (including preparing a summary schedule of prior audit findings and a separate corrective action plan).
- Taking reasonable measures to safeguard protected personally identifiable information and other information the federal awarding agency or pass-through entity designates as sensitive or the entity considers sensitive consistent with applicable federal, state, and local laws regarding privacy and obligations of confidentially.
- Providing the auditor with access to personnel, accounts, books, records, supporting documentation, and other information needed for the audit.

The Uniform Guidance, at 2 CFR section 200.508(b), requires the auditee to prepare appropriate financial statements, including a schedule of expenditures of federal awards. The requirement to present a schedule of expenditures of federal awards means that the auditee should identify all of its federal programs (direct and indirect, major and nonmajor) and related awards expended. As part of the planning process, the auditee should provide the auditor with the schedule of expenditures of federal awards as well as information reconciling the schedule to the financial statements and underlying accounting records, such as the general ledger and reimbursement requests.

The Uniform Guidance, at 2 CFR sections 200.508(c) and 200.511(a), requires the auditee to prepare a summary schedule of prior audit findings. As part of the planning process, auditees should provide documentation supporting the status of prior year findings included on the summary schedule.

The following is a listing of additional potential tasks that the client could perform during the planning process:

- Determine type of award/contract (i.e., contractor versus subrecipient).
- Identify significant contractor relationships where the contractor is responsible for program compliance.
- Make copies of contracts, original budgets, budget revisions, correspondence with federal awarding agencies and pass-through entities, and audit results performed by federal awarding agencies and pass-through entities.
- Identify the award date and whether the award is subject to the administrative requirements and cost principles in the Uniform Guidance or those in the previous OMB circulars.
- Identify specific audit and reporting requirements for each award.
- Identify specific compliance requirements for federal award programs. [The Compliance Supplement includes specific compliance requirements for some of the largest federal programs. 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.
- Provide documentation of the entity's compliance with compliance requirements that could have a direct and material effect on each of its federal programs. (Such documentation might include accounting or statistical data, case files, policy or accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, or internal auditors' reports.)
- Contact nonfederal awarding agencies and determine if any funds received are federal pass-through funds.
- Provide documentation of internal control systems impacting federal funds.
- Provide a written cost allocation plan and supporting documentation for costs allocated to federal programs.

The client and auditor will both benefit from the client being involved in the planning of the single audit. Through review of specific audit requirements, client personnel may gain knowledge which will assist in the administration of federal grants. In addition to reducing audit staff hours, the auditor will benefit during fee negotiations if the client gains an understanding of the complexity of the audit process.

SELF-STUDY QUIZ

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

11. Which of the following correctly explains how an auditor should determine materiality for the single audit?

    a. The auditor should determine and apply materiality levels based on the financial statement audit requirement.

    b. The auditor should specify the same level of materiality for each audit purpose.

    c. The auditor's consideration of materiality for audit planning purposes is a quantitative consideration.

    d. For a certain instance of noncompliance, the auditor's assessment of materiality will depend on the particular compliance requirements being evaluated.

12. Robert is an auditor who is determining overall responses to address risks of material misstatement at the financial statement level. Which of the following responses would be appropriate?

    a. Changing the timing, nature, and extent of substantive procedures.

    b. Emphasizing that the entity's management should use professional skepticism.

    c. Avoiding the use of specialists.

    d. Using a high degree of predictability when selecting audit procedures.

13. Which of the steps listed below for establishing the overall audit strategy is considered the heart of determining nature, timing, and extent of audit procedures that will be needed in the audit?

    a. Determine the nature, timing, and extent of resources needed to perform the audit.

    b. Consider the results of preliminary audit activities.

    c. Consider the significant factors that will determine the focus of the audit team's efforts.

    d. Determine the reporting objectives of the engagement.

14. Which of the following is a condition that is usually present when fraud occurs and is described as management or other employees being able to justify the acceptability of committing fraud?

    a. Attitude and rationalization.

    b. Incentive and pressure.

    c. Opportunity.

    d. Defalcation.

15. Denise is performing audit procedures for a single audit. Which of the following should Denise consider when performing her audit procedures?

    a. Denise should base her opinion on the evidence obtained in her risk assessment procedures.

    b. Denise should design audit procedures to detect both intentional and unintentional noncompliance.

    c. Denise should limit her risk assessment procedures to only inquiries.

    d. Denise must perform risk assessment procedures separately from tests of controls.

16. Which of the following accurately describes the use of internal auditors during a single audit?

    a. Internal auditors can make important judgments in the audit engagement.

    b. It is inappropriate for external auditors to use internal auditors to reduce their work on the audit.

    c. The external auditor may be able to use the internal auditor's regular work to assist in obtaining an understanding of internal control.

    d. Internal auditors cannot perform tests of controls to assist the external auditor.

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. Which of the following correctly explains how an auditor should determine materiality for the single audit? **(Page 335)**

    a. The auditor should determine and apply materiality levels based on the financial statement audit requirement. [This answer is incorrect. AU-C 935.13 states that the auditor should determine and apply materiality levels based on the governmental audit requirement, not the financial statement audit requirement.]

    b. The auditor should specify the same level of materiality for each audit purpose. [This answer is incorrect. Governmental audit requirements may specify a different level of materiality for certain purposes. For example, the Uniform Guidance establishes a lower materiality threshold for reporting findings of noncompliance. Therefore, the auditor should not set all materiality levels the same.]

    c. The auditor's consideration of materiality for audit planning purposes is a quantitative consideration. [This answer is incorrect. The consideration of materiality for planning purposes should be a qualitative consideration rather than quantitative. The auditor will then use the preliminary judgment about materiality to make audit scope decisions.]

    d. For a certain instance of noncompliance, the auditor's assessment of materiality will depend on the particular compliance requirements being evaluated. [This answer is correct. Under the Uniform Guidance, there are several levels of materiality relating to a single audit. The auditor's assessment of materiality for a specific instance of noncompliance will depend on the particular compliance requirement that is being evaluated.]

12. Robert is an auditor who is determining overall responses to address risks of material misstatement at the financial statement level. Which of the following responses would be appropriate? **(Page 337**)

    a. Changing the timing, nature, and extent of substantive procedures. [This answer is correct. Robert should consider changing the nature, timing, and extent of substantive audit procedures. For example, shift testing to period end instead of interim or modify the nature of audit procedures to obtain more persuasive evidence.]

    b. Emphasizing that the entity's management should use professional skepticism. [This answer is incorrect. AU-C 330.A1 provides guidance to auditors when determining overall responses to address risk of material misstatement at the financial statement level. One of the recommended responses is for the audit team, not the entity's management, to place emphasis on professional skepticism.]

    c. Avoiding the use of specialists. [This answer is incorrect. One of the appropriate responses includes assigning staff with higher experience levels or specialized skills or using specialists.]

    d. Using a high degree of predictability when selecting audit procedures. [This answer is incorrect. One of the suggested responses is for the auditor to use a greater degree of unpredictability in selecting audit procedures.]

13. Which of the steps listed below for establishing the overall audit strategy is considered the heart of determining nature, timing, and extent of audit procedures that will be needed in the audit? **(Page 339**)

    a. Determine the nature, timing, and extent of resources needed to perform the audit. [This answer is incorrect. This step from AU-C 300.08 concerns the personnel resources that will be necessary to accomplish audit objectives, including the need for the involvement of specialists or experts. This is not considered the heart of determining the nature, timing, and extent of necessary audit procedures.]

b. Consider the results of preliminary audit activities. [This answer is incorrect. This a step listed in AU-C 300.08 to establish the overall audit strategy. However, this activity concerns additional information that also may affect the focus of the engagement team's efforts. It is not considered the heart of determining necessary audit procedures.]

c. Consider the significant factors that will determine the focus of the audit team's efforts. [This answer is correct. AU-C 300.08 provides several steps that the auditor should perform when establishing the overall audit strategy, one of which is considering the significant factors determining the focus of the audit team's efforts. This step is considered to be the heart of determining the nature, timing, and extent of necessary audit procedures.]

d. Determine the reporting objectives of the engagement. [This answer is incorrect. Determining the reporting objectives of the engagement to plan the timing of the audit and the nature of communications required is a step the auditor should perform to establish the overall audit strategy. However, it is a relatively straightforward factual determination of written and other communications required, not the heart of determining necessary audit procedures.]

14. Which of the following is a condition that is usually present when fraud occurs and is described as management or other employees being able to justify the acceptability of committing fraud? **(Page 343)**

a. Attitude and rationalization. [This answer is correct. Three conditions are generally present when fraud occurs. Attitude and rationalization is the condition described as management or other employees being able to justify the acceptability of committing fraud.]

b. Incentive and pressure. [This answer is incorrect. This is a condition that is generally present when fraud occurs. However, it is when management or other employees have a reason to commit fraud, not a justification for committing fraud.]

c. Opportunity. [This answer is incorrect. Generally, when fraud occurs, this condition is present. Opportunity is present when the circumstances enable management or other employees to commit fraud, not the justification for committing fraud.]

d. Defalcation. [This answer is incorrect. Misstatements resulting from misappropriation of assets are often referred to as defalcation, embezzlement, theft, or employee fraud. This is a type of fraud, not a condition that is generally present when fraud occurs.]

15. Denise is performing audit procedures for a single audit. Which of the following should Denise consider when performing her audit procedures? **(Page 350)**

a. Denise should base her opinion on the evidence obtained in her risk assessment procedures. [This answer is incorrect. AU-C 315.05 explains that the auditor should perform risk assessment procedures. However, risk assessment procedures alone do not provide sufficient appropriate audit evidence on which to base an opinion. In all circumstances, further audit procedures are necessary to support an opinion.]

b. Denise should design audit procedures to detect both intentional and unintentional noncompliance. [This answer is correct. The GAS/SA Audit Guide explains that auditors must perform tests of transactions and other auditing procedures necessary to provide sufficient appropriate audit evidence to support an opinion for each major program. This will require Denise to design her procedures to detect intentional and unintentional compliance. Procedures that are effective for detecting unintentional noncompliance may not be effective for detecting intentional noncompliance that is concealed through collusion.]

c. Denise should limit her risk assessment procedures to only inquiries. [This answer is incorrect. A variety of risk assessment procedures should be used when obtaining an understanding of the entity and its environment. Denise cannot limit her risk assessment procedures to inquiry alone.]

d. Denise must perform risk assessment procedures separately from tests of controls. [This answer is incorrect. Performing risk assessment procedures may provide audit evidence about relevant assertions related to account balances, transaction classes, or disclosures. Therefore, risk assessment procedures may also serve as tests of controls or substantive procedures, or may be performed concurrently with those procedures.]

16. Which of the following accurately describes the use of internal auditors during a single audit? **(Page 357)**

a. Internal auditors can make important judgments in the audit engagement. [This answer is incorrect. The use of internal auditors or their work might affect the auditor's procedures. However the external auditor is solely responsible for performing procedures to obtain sufficient appropriate audit evidence to support the auditor's report. The external auditor should make all significant judgments in the audit engagement.]

b. It is inappropriate for external auditors to use internal auditors to reduce their work on the audit. [This answer is incorrect. After obtaining an understanding of the internal audit function, the external auditor may be able to use internal auditors to reduce work on the audit. Doing so would not be considered inappropriate, and information about doing so is provided in AU-C 610, *Using the Word of Internal Auditors.*]

c. The external auditor may be able to use the internal auditor's regular work to assist in obtaining an understanding of internal control. [This answer is correct. Once the external auditor has obtained an understanding of the internal audit function, the internal auditor's regular work performed during the period may be used to assist the external auditor. One of these uses would be to assist the external auditor in obtaining an understanding of internal control (such as by obtaining documentation relating to internal control and responding to auditor's inquiries.)]

d. Internal auditors cannot perform tests of controls to assist the external auditor. [This answer is incorrect. Once the external auditor obtains an understanding of the internal audit function, the internal auditors may be used for direct assistance during the audit. The internal auditors may perform certain procedures (such as tests of controls or substantive tests) under the external auditor's direction, supervision, and review.]

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 Uniform Guidance compliance audit part of the audit as opposed to the financial statement audit part. Tests of controls over compliance using audit sampling are discussed later in this lesson.

The Single Audit Act Amendments of 1996 and the Uniform Guidance do not require statistical sampling. The Uniform Guidance 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 sufficient appropriate audit evidence about the entity's compliance with federal statutes, regulations, and the terms and conditions of federal awards 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 the provisions of federal statutes, regulations, and the terms and conditions of federal awards, noncompliance with which could have a material effect on the financial statements. Neither the standards for application of GAAS to compliance audits at AU-C 935, the standards for the consideration of fraud at AU-C 240, nor the specific requirements for single audits in the Uniform Guidance require separate audit procedures for these tests of compliance. If instances of noncompliance are discovered during the single audit tests of compliance, however, the auditor needs to consider the potential effect of the noncompliance on the entity's financial statements and on compliance of the individual federal award program. This course focuses primarily on the single audit. The relationship of single audit procedures to the financial statement audit are discussed further later in this lesson.

Evidence about an entity's compliance with federal statutes, regulations, and the terms and conditions of federal awards can be obtained by using audit sampling when performing:

- 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 of noncompliance 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.

A section later in this lesson discusses compliance testing considerations when a major program has expenditures from federal awards that are subject to administrative requirements and cost principles in the Uniform Guidance as well as expenditures that are subject to pre-Uniform Guidance administrative requirements and cost principles.

The GAS/SA Audit Guide, Paragraph 11.07, explains that attributes sampling is typically used for tests of controls over compliance and tests of compliance. In tests of controls over compliance, the auditor is most concerned about the rate of deviation from the prescribed control. In tests of compliance, the auditor is concerned not only about the rate of noncompliance, but also the likely magnitude of noncompliance.

Certain audit procedures do not involve audit sampling, such as when the auditor decides to examine every item in a population relating to a type of compliance requirement for a major program or when the auditor identifies a few large or unusual items that are individually important and tests them separately from the remaining population.

Paragraph 11.31 of the GAS/SA Audit Guide explains that when designing an audit sample, the auditor should consider the purpose of the audit procedure (for example, to determine whether a necessary control was performed effectively or whether a certain expenditure was allowable under the applicable cost principles).

Paragraph 11.42 of the GAS/SA Audit Guide explains that, for purposes of testing controls, transactions for major programs that have common controls for a type of compliance requirement can be combined into one population for determining sample size and selecting the sample. However, as discussed later in this lesson, for purposes of testing compliance, each major program is usually considered to be a separate population because of the need to provide clear evidence of the compliance tests performed, the results of those tests, and the conclusions reached. The GAS/SA Audit Guide does not, however, require the use of a separate sample for each major program. If the auditor chooses to select the sample from a population consisting of multiple major programs, it is important to document how the results relate to each of the major programs and how that evidence, combined with other audit evidence, is sufficient to support the opinion on each major program's compliance.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the requirements that apply to all Single Audit samples and guidelines for performing tests of controls over compliance.
- Determine how to perform and plan the extent of substantive tests of compliance.

Authoritative Literature

The authoritative pronouncements that establish requirements or provide suggestions that most directly affect the use of audit sampling are as follows:

- AU-C 530, *Audit Sampling*.
- AICPA Audit Guide, *Audit Sampling* (the AICPA Sampling Guide).
- Title 2 U.S. *Code of Federal Regulations* (CFR), Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). (The most current version of 2 CFR part 200 is in the Electronic Code of Federal Regulations (eCFR) at **www.ecfr.gov**/**cgi-bin**/**text-idx?tpl**=/**ecfrbrowse**/**Title02**/**2cfr200_main_02.tpl**.)
- AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide).

GAS/SA Audit Guide Sampling Guidance. The AICPA provides extensive guidance on single audit sampling in Chapter 11 of the GAS/SA Audit Guide. Key elements of that sampling guidance include the following:

- *Sample Sizes.* Chapter 11 of the GAS/SA Audit Guide provides suggested minimum sample sizes as well as methods for determining sample size, including different tables and methods for tests of controls than for tests of compliance.
  - The size of the sample for a test of internal controls over compliance depends on the auditor's assessment of the significance of the control being tested and the inherent risk of the compliance requirement.
  - The size of the sample for a test of compliance depends on the auditor's assessment of the remaining risk of material noncompliance after risk assessment procedures, tests of controls, tests of individually important items, and other audit procedures are performed. Types of compliance requirements that present a high remaining risk of material noncompliance would require a sample that provides high assurance, whereas other types of compliance requirements might present a low remaining risk of material noncompliance.

  Depending on the nature of the compliance requirement, the results of other audit procedures, and the risks and complexities of the sampling population, the auditor might determine, based on professional judgment, that a larger sample size than the suggested minimum sample size is appropriate.

- *Dual Purpose Tests.* The sample size for a dual test of controls and compliance will usually be the larger of the one that would be used if the control and compliance samples were tested separately. Also, even

if performed as dual purpose tests, tests of controls and tests of compliance should be documented separately in order to clearly distinguish between the audit objectives and test results for each test and to enable the auditor to reach separate conclusions on the internal control attributes and the compliance attributes tested.

- *Control Deviations and Compliance Exceptions.* For tests of controls, a deviation is a departure from the expected performance of the prescribed control. The tolerable deviation rate is the maximum rate of deviation from a prescribed control the auditor is willing to accept without altering the planned assessed level of control risk of noncompliance. For tests of compliance, an exception is a departure from federal statutes, regulations, and the terms and conditions of federal awards being tested. The tolerable exception rate is the maximum rate of compliance exceptions the auditor is willing to accept.

- *Individually Important Items.* Chapter 11 of the GAS/SA Audit Guide establishes the concept of identifying individually important items to be subjected to separate tests of compliance. (This is similar to the concept of identifying significant dollar items in a financial statement audit.)

- *Sampling Documentation.* Documentation is affected by several factors, including the size and complexity of the entity, the nature and complexity of the compliance requirements and of internal control over compliance, and the auditee's past experience relative to compliance.

Definition of Audit Sampling

Audit sampling is defined by AU-C 530.05 as:

> The selection and evaluation of less than 100 percent of the population of audit relevance such that the auditor expects the items selected (the sample) to be representative of the population and, thus, likely to provide a reasonable basis for conclusions about the population. In this context *representative* means that evaluation of the sample will result in conclusions that, subject to the limitations of sampling risk, are similar to those that would be drawn if the same procedures were applied to the entire population.

This definition is important in the selection of audit procedures since, by definition, some audit procedures are not sampling. Examples include the following:

a. 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.

b. Examining a few transactions within a balance or class of transactions to obtain an understanding of the nature of the transactions.

c. Applying an audit procedure to one or a few transactions to clarify the auditor's understanding of the entity's internal control over compliance.

In each of these three examples, the auditor is not selecting items expected to be representative of the population to provide a reasonable basis for drawing conclusions about the population from which the items were selected. In item a, the auditor is dividing the account balance or transaction class into two populations and selecting 100 percent of one of those populations. In items b and c, the auditor is selecting items to obtain information that will increase the auditor's understanding rather than attempting to reach a conclusion about a population of items. In each of these cases, authoritative standards on sampling would not apply to the test performed.

The definition of audit sampling 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, AU-C 530 imposes certain requirements that may be difficult to meet.

However, the auditor cannot ignore the requirements of AU-C 530 by arbitrarily failing to project the results of a sample. Thus, when the auditor reaches a conclusion about 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 AU-C 530.

Audit Sampling in Single Audits

Audit sampling in single audits may be used for both tests of controls and substantive tests of compliance. Controls are tested for two reasons: (a) to support a low assessed level of control risk of noncompliance for major programs and (b) to obtain appropriate audit evidence about whether internal controls used in administering federal award programs are operating effectively. Also, as discussed later in this lesson, tests of controls over compliance, tests of compliance, and substantive tests of transactions may be performed simultaneously as a multi-purpose test.

REQUIREMENTS THAT APPLY TO ALL SINGLE AUDIT SAMPLES

The two possible approaches to audit sampling are nonstatistical and statistical. Both of these approaches are capable of producing appropriate audit evidence, when properly applied. AU-C 530.A14 and the AICPA Sampling Guide (Paragraph 2.28), explain that while an auditor using nonstatistical sampling is not required to compute sample size using statistical theory, the sample sizes of statistical and nonstatistical samples ordinarily can be expected to be comparable when the same sampling parameters are used.

The types of procedures that the auditor applies are not determined by the sampling approach used. Either approach (statistical or nonstatistical) may be used to apply whatever tests of details the auditor deems necessary in the circumstances. The importance of professional judgment and professional skepticism cannot be overemphasized as they apply 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 and professional skepticism are needed to relate the sample results to other audit evidence when the auditor forms a conclusion about compliance with federal statutes, regulations, and the terms and conditions of federal awards. 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 to use. Substantial information is given in the AICPA Sampling Guide, and other sources on the use of various statistical sampling approaches. In this lesson, emphasis is placed on *nonstatistical* sampling.

The Basic Requirements

The basic requirements that relate to all single audit samples—statistical and nonstatistical—are as follows:

- *Defining.* The auditor considers the purpose of the procedure and the characteristics of the population being sampled. 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 selects items that can be expected to be representative of the population.
- *Performing.* The auditor performs appropriate audit procedures on each sample item and investigates the nature and cause of any deviations or misstatements.
- *Evaluating.* The auditor projects sample results to the population, considers sampling risk, and evaluates whether the use of sampling provided a reasonable basis for drawing conclusions about the population tested.

Defining Population and Sampling Unit

Defining the Population. According to Paragraph 11.34 of the GAS/SA Audit Guide, the sampling population includes the individual transactions of interest for an audit objective related to a particular control or type of compliance requirement remaining after removing items that are to be tested separately without using sampling, such as individually important items or a subset of items that are tested 100 percent. Individually important items are those that, standing alone, are significantly different from the rest of the population, for example, increased activity around a certain time period such as journal entries made at the beginning or end of an award. They might be large, risky, or unusual items or transactions that contain characteristics of a prior compliance finding. It is

important to note that identifying individually important items for separate testing applies only to compliance testing and not to testing of internal control over compliance.

In a single audit sampling application, the population may consist of monetary items (for example, 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) or nonmonetary items [for example, all transactions of a certain type (e.g., reports filed or timesheets prepared) for all major programs, or all transactions of a certain type for a specific major program, or all transactions of a certain type for a specific department].

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 achieve an efficient and effective sampling application. Examples of sampling units include individual subrecipient awards or contracts, award expense checks, payroll checks, etc.

Before defining the sampling unit, it is important to determine how the auditee maintains its records (for example, by participant, by program, by location). The GAS/SA Audit Guide, Paragraph 11.40, explains that the definition of the sampling unit depends on the audit objective and the nature of the audit procedures to be applied. For example, a sampling unit for a test of controls related to the Activities Allowed or Unallowed type of compliance requirement might be a payment voucher, a journal entry, or another document that has evidence of approval or review of the allowability of the expenditure. A sampling unit might provide evidence for more than one internal control. For example, a voucher package might provide evidence that the amounts were checked for accuracy, the contractor was checked for suspension and debarment, the expenditure was for an allowable activity and was an allowable cost, and that the expenditure was incurred and obligated within the period of performance.

Appropriateness of Sampling Population and Sampling Unit. The GAS/SA Audit Guide, Paragraph 11.33, states that the auditor should determine that the sampling population and sampling unit are appropriate for the specific audit objective because sample results can be projected only to the particular population from which the sample was selected. For example, if the auditor plans to test timesheets from multiple departments for proper authorization, the auditor might first determine if the departmental timesheets make up one population or separate populations by considering whether the systems and controls for approval are the same or different among the departments. A sampling population might be defined as a period of time (for example, the *OMB Compliance Supplement* defines certain time periods as a sampling population for the Period of Performance type of compliance requirement). The use of the wrong population or sampling unit could mean that the auditor may make incorrect conclusions based on the sample.

Representative Selection

Selecting Sample Items. The *OMB Compliance Supplement* (Compliance Supplement) uses the phrase "select a sample" at various locations. AU-C 530.08 requires a "representative sample." The GAS/SA Audit Guide, at Paragraph 11.37, further explains that the auditor should select items in such a way that the auditor can reasonably expect the sample to be representative of the relevant population. The AICPA Sampling Guide (Paragraph 1.05) explains that a representative sample is free from selection bias. At Paragraph 3.29 it further explains that to be representative, all items in the population need to have an opportunity to be selected. There are several commonly used methods of selecting samples consistent with this guidance. The following are some of those methods:

a. *Random Selection.* Regardless of the method of sampling used, statistical or nonstatistical, random selection provides each item in the population an equal chance of being selected.

b. *Systematic Selection.* 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.

c. *Haphazard Selection.* Under this method, 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. This method may not be used for statistical samples, however, because it is not considered a random selection technique. As explained in the GAS/SA Audit Guide, Paragraph 11.96, haphazard selection is not appropriate for statistical sampling because it does not enable the auditor to measure the probability of selecting a combination of sampling units.

An auditor also qualitatively evaluates whether the sample selected seems representative of the population subjected to the audit procedures and is likely to provide a reasonable basis for drawing conclusions about the population. For example, if the auditor is selecting a sample of federal award expenditure checks with a sample size of 60, a sample that included 20 employee expense reimbursement checks might not be considered representative of the population subjected to the audit procedures or likely to provide a reasonable basis for drawing conclusions about federal award expenditures. If the sample does not seem representative, it should be reselected.

If the sample that was selected does not include an attribute being tested, the sampling population might not have been defined properly. The GAS/SA Audit Guide, Paragraph 11.38, explains that in this situation, the auditor might consider keeping the original sample and adding other items that include the attribute which was originally excluded. The number of additional items to be considered is a matter of professional judgment.

The GAS/SA Audit Guide, Paragraph 11.37, states that the auditor should develop and perform audit procedures sufficient to conclude that the population includes all transactions of interest for the specific audit objective (i.e., that the population is complete). In order to substantiate the completeness of the population, the auditor might reconcile the population to accounting records, other relevant records, or the schedule of expenditures of federal awards, or could perform other procedures. It is important to note that the population might not consist of accounting records; for example, eligibility files do not directly relate to amounts in the financial statements.

Choosing a Method. The auditor might consider using random selection (with a random number table or computer-generated numbers) or systematic selection with several random starts when performing nonstatistical sampling. 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.

Considering Clusters of Programs

When sampling is used for a cluster of programs, the auditor should obtain sufficient appropriate audit evidence for the direct and material types of compliance requirements of the clustered programs as a whole. The GAS/SA Audit Guide, Paragraph 11.46, states that random or haphazard selection of sample items from a cluster generally would provide a representative sample. Paragraph 11.48 states that an alternative method of selecting sample items in a cluster might be for the auditor to analyze the cluster transactions (for example, expenses) and federal awards before selecting the sample and then to allocate the sample to the transactions or programs in proportion to the overall cluster. This alternative might be difficult to execute depending on how the auditee keeps their records.

If the initial sample does not appear to be representative because it does not include items relating to certain direct and material types of compliance requirements for specific programs within the cluster, the auditor would use professional judgment to determine what additional evidence is needed. Paragraph 11.47 of the GAS/SA Audit Guide suggests factors that might be considered in this determination include the following:

- the consistency of processing controls over the various programs within the cluster;
- the volume of transactions and the size of expenditures for a particular program as a component of the overall cluster being tested;
- the complexity of the compliance requirements; and
- the past history of compliance.

Evaluating Sample Results

The evaluation of sample results has three aspects. AU-C 530.13 requires the auditor to project the results of audit sampling to the population. The auditor needs to calculate the compliance exception rate and, if applicable, likely questioned costs (or, in a test of controls, calculate the deviation rate). AU-C 530.14 indicates that the auditor should evaluate the results of audit sampling, including sampling risk (i.e., the risk that the auditor's conclusions based on a sample may be different from the conclusions reached if the entire population had been subjected to the same audit procedure). In a statistical sample, the effect of sampling risk is objectively measured using probability theory. In a nonstatistical sample, sampling risk still needs to be considered and restricted to a relatively low level but the effect cannot be objectively measured. This is the primary conceptual distinction between statistical and nonstatistical sampling. In the nonstatistical sampling approaches presented in this lesson, sampling risk is assessed by considering whether the rate or amount of deviations and exceptions identified in the sample exceed the expected rate or amount of deviations and exceptions used in designing the sample. Finally, the auditor should evaluate whether the sample has provided a reasonable basis for drawing conclusions about the population being tested. This is separate from the consideration of whether the sample is representative of the population made when selecting the sample. It includes an overall evaluation of the sample results and whether additional procedures are necessary, such as asking the client to investigate and make necessary corrections or changing the nature, timing, or extent of the auditor's procedures.

Whenever a control deviation or a compliance exception is identified, the auditor should investigate its nature and cause and evaluate the possible effect on the purpose of the audit procedure and on other areas of the audit. Understanding the potential effect will assist in the determination of (a) whether sufficient appropriate evidence was obtained to support the opinion on compliance and (b) whether to report an internal control finding, compliance finding, or both. The GAS/SA Audit Guide, Paragraph 11.101, identifies the following factors the auditor might consider when evaluating deviations and exceptions:

- *The systematic nature of the deviation or exception.* A deviation or exception that is systematic in nature is more likely to result in an audit finding than one that is isolated to a subset of the population.

- *Whether the deviation or exception is intentional.* The auditor's discovery of fraud requires a broader consideration of its possible implications than does the discovery of a deviation or exception due to a mistake or lack of understanding.

- *The pattern relative to past history.* A pattern of control deviations or compliance exceptions may require the auditor to perform additional tests to determine the effect of current period findings or instances of noncompliance that are similar to findings or material noncompliance reported in prior audits. The failure to correct deficiencies in internal control over compliance or compliance exceptions identified in prior years is a relevant factor in the evaluation.

Documentation of Sampling Procedures

AU-C 935.40 states that the auditor should document the responses to the assessed risks of material noncompliance, procedures performed to test compliance with applicable compliance requirements (including tests of controls over compliance), and the results of the procedures.

Documentation of sampling in a Uniform Guidance audit of compliance is influenced by several factors, including the size and complexity of the entity, the nature and complexity of the compliance requirements and of internal control over compliance, and the entity's past experience relative to compliance. The GAS/SA Audit Guide, Paragraph 11.135, provides the following examples of items the auditor typically documents for sampling in an audit of compliance:

- A description of the control or type of compliance requirement being tested.

- Definitions of the population and the sampling unit, including how completeness of the population was determined.

- The definition of a deviation or exception.

- The desired confidence or assurance level, tolerable deviation or exception rate, and expected population deviation or exception rate.
- The sample size.
- The sample selection method (e.g., random, haphazard, or systematic selection).
- The selected sample items, including identifying characteristics of the specific items tested, clear documentation that supports both tests of controls and tests of compliance when dual purpose tests are performed, and resolution of missing documents.
- An evaluation of the sample, including:
  - The number of deviations or exceptions noted.
  - Important qualitative aspects of the deviation(s) or exception(s).
  - The projected population deviation or exception rate.
  - The auditor's determination of whether the sample results support the test objective.
  - The effect of the evaluation on other audit procedures (for example, if tests of controls do not support a low assessed level of control risk of noncompliance for major programs, consideration of the effect on tests of compliance).
  - Known questioned costs and estimated likely questioned costs.
  - Whether deviation(s) or exception(s) require the auditor to modify the opinion on compliance or report a finding and, if not, how the auditor considered sampling risk.
- Qualitative factors considered significant in making the sampling, selections, assessments, and judgments. (This may include multiple major programs, multiple organizational units, clusters, or other factors.)
- The overall conclusion (if not evident from the results).

TESTS OF CONTROLS OVER COMPLIANCE

Irrespective of the fact that tests of controls are required by the Uniform Guidance and AU-C 935.20, 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 (including federal statutes) and the provisions of contracts or grant agreements (including federal awards).
- To obtain a reduced control risk of noncompliance 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 federal statutes, regulations, and the terms and conditions of federal awards that have a direct and material effect on each major program [the Single Audit Act Amendments of 1996, Section 7502(e)(4)]. 2 CFR section 200.514(c)(2)–(3) and Paragraph 9.08 of the GAS/SA Audit Guide, indicate that it is the auditor's responsibility to perform tests of these controls. To accomplish this, the auditor must:

- Perform procedures to obtain an understanding of internal control over compliance sufficient to plan the audit to support a low assessed level of control risk of noncompliance for major programs.

- Plan tests of internal control over compliance for major programs to support a low assessed level of control risk of noncompliance for the assertions relevant to the compliance requirements for each major program.
- Perform tests of internal control over compliance as planned.
- Report on internal control over compliance describing the scope and results of the testing and, where applicable, referring to the separate schedule of findings and questioned costs.

This process of testing internal controls and assessing control risk of noncompliance also provides audit evidence 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

2 CFR section 200.514(c) 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 and correcting, material noncompliance with the direct and material compliance requirements. The auditor is generally required by the Uniform Guidance 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 maximum. The only exception to the requirement to test controls is those areas where controls are likely to be ineffective. The Uniform Guidance makes it clear, though, that, in such a case, the auditor must report a significant deficiency or material weakness related to the control(s) not tested, assess control risk at the maximum, and consider whether additional compliance tests are required because of ineffective internal control.

Multi-purpose Tests

When performing single audits, an effective approach may be to perform tests of controls that involve sampling simultaneously with tests of compliance with laws and regulations (a dual-purpose test). Additionally, these tests may, in some instances, also serve as a substantive test of one or more account balances (a triple-purpose test). Audit procedures designed to test expenditures charged to major federal award programs for compliance with relevant federal statutes, regulations, and the terms and conditions of federal awards will simultaneously test the operating effectiveness of control activities designed to ensure compliance with those statutes, regulations, and award terms and conditions. In some cases, there is no real distinction between tests of compliance with program requirements and tests of controls over program requirements. Paragraph 11.52 of the GAS/SA Audit Guide states that the sample size for a dual purpose test of controls and compliance will usually be the larger of the one that would be used if the control and compliance samples were tested separately. Also, tests of controls and tests of compliance should be documented separately so there is a clear distinction between the audit objectives and test results for each test and to enable separate conclusions to be reached on the internal control attributes and compliance attributes tested.

When using a dual purpose sample for both internal control and compliance testing, it is important to align the objectives of the test to the same sampling unit and population so that the population from which the sample is selected is appropriate for the specific audit objectives. In dual purpose tests, audit findings should be evaluated separately for the controls and the compliance attributes tested. The basis for the evaluation of the control will be its operation and not just whether the auditee complied. Because a control that is not properly applied might not result in noncompliance, the auditor's conclusions about controls might be different than his or her conclusions about compliance for the same sample item (e.g., the auditor might report a significant deficiency or material weakness in internal control over compliance but not a compliance related finding).

Control deviations, including those relating to controls tested as part of a dual purpose sample, present an increased risk of noncompliance and might necessitate a larger sample than originally planned for the related tests of compliance. The auditor should use the knowledge obtained about internal control over compliance to identify types of potential noncompliance, consider factors that affect the risk of material noncompliance, and design appropriate tests of compliance.

Need to Exercise Caution. Auditors need to exercise caution when performing and documenting dual purpose testing. An Emphasis Point at Paragraph 9.38 of the GAS/SA Audit Guide points out that some quality control

reviews performed by federal agencies had findings that auditors using dual purpose testing did not clearly identify the procedures performed to test compliance versus procedures used to test the operating effectiveness of internal control over compliance. Documentation for dual purpose tests needs to separately identify the two types of tests and the results of those tests.

Considering Multiple Organizational Units

When the auditee has operations in multiple organizational units (e.g., operating units, locations, or branches), each organizational unit might maintain separate internal control over compliance for the programs, or parts of programs, that it administers. In these situations, the auditor should consider his or her understanding of internal control over compliance to determine whether each organizational unit would be defined as a separate population.

The GAS/SA Audit Guide, Paragraph 11.45, explains that if controls over compliance or compliance procedures at different organizational units vary significantly, it might be necessary to treat each as a separate population. When transactions are processed in organizational units using the same controls or compliance procedures are performed under common oversight and monitoring, the auditor might select one overall sample across the organizational units (for example, selecting from centralized locations or visiting all organizational units). If controls and/or compliance procedures are the same across the organizational units, but sufficient appropriate audit evidence cannot be obtained centrally or by visiting all of the organizational units, the auditor typically would select some organizational units from which to obtain audit evidence. In this circumstance, the auditor might consider (a) testing at least the minimum sample size at each location of significance (or, possibly choosing a larger sample size based on the results of risk assessment procedures) or (b) varying the selection of the less significant organizational units included in the testing from year to year.

Sampling in Tests of Controls over Compliance

Although not required for tests of controls, sampling may be used and can be very efficient. However, sampling in a compliance audit differs from sampling in a financial statement audit. Chapter 11 of the GAS/SA Audit Guide provides extensive guidance on sampling in a Uniform Guidance audit of compliance. The guidance establishes different sampling terminology and methodology than used in the financial statement audit environment. It also provides suggested minimum sample sizes, which are determined differently for tests of controls over compliance than for tests of compliance. Paragraph 11.58 of the GAS/SA Audit Guide explains that sample sizes should be considered separately for internal control testing and compliance testing because the objectives for tests of controls and tests of compliance are different and have different factors to consider when determining sample sizes.

Uniform Guidance Transition Considerations

Nonfederal entities (i.e., award recipients) have to implement the administrative requirements and cost principles in the Uniform Guidance for all new federal awards made on or after December 26, 2014, and for funding increments (additional funding on existing awards) with modified terms and conditions awarded on or after that date. Paragraphs 6.77 and 11.138 of the GAS/SA Audit Guide explain that auditors should consider whether auditees may have updated or revised their internal control over compliance as they become more familiar with the requirements of the Uniform Guidance. Paragraph 11.138 points out that in situations where controls have changed in the current year, the previous year's results of internal control testing may not have an impact on planning current year tests of controls. Additionally, when there have been internal control changes in the current year it may be necessary to choose separate samples for controls testing.

Terminology for Sampling in Tests of Controls

The discussion in this section uses the following sampling terms:

- *Deviation*—Departure from the expected performance of the prescribed control.
- *Tolerable Deviation Rate*—The maximum rate of deviation from a prescribed control that auditors are willing to accept without altering the planned assessed level of control risk of noncompliance.

- *Risk of Overreliance*—The aspect of sampling risk that is the risk of erroneously concluding that the controls are more effective than they actually are. (This risk relates to audit effectiveness because the auditor who overrelies on controls inappropriately reduces the evidence obtained from substantive procedures.)

- *Expected Deviation Rate*—The rate of deviations the auditor expects based on prior experience and knowledge of the characteristics of the population.

- *Sampling Risk*—The risk that the auditor's conclusions based on a sample may be different from the conclusions if the entire population had been subjected to the same audit procedure.

- *Significant Controls*—All controls that the auditor determines must be tested to mitigate the risk of material noncompliance.

- *Population*—The class of transactions being sampled.

- *Sampling Unit*—The individual items that are subjected to audit procedures and that represent the components of the population.

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. The remainder of the discussion in this section explains what those additional considerations are and how they affect tests of controls.

Exhibit 2-1

Tests of Controls Using Audit Sampling

Step 1 Identify suitable controls to test and the related substantive compliance procedures that would be reduced in reliance on the controls.

Step 2 Consider whether testing controls is practical.[a]

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.

1. Define "deviation" for purposes of the test.
2. Define the population to be sampled.
3. Define the sampling unit.
4. Determine the tolerable rate of deviations.
5. Determine the allowable risk of assessing control risk too low (risk of overreliance).
6. Determine the expected rate of deviations.
7. Compute the sample size.
8. Determine the method of sample selection.

Step 4 Perform tests of controls.

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 the Uniform Guidance requires tests of controls.

* * *

Step 1—Identifying Controls and Related Substantive Compliance Procedures

The first step in planning the sample is to identify the controls to be tested and, if applicable, the related substantive compliance procedures to be reduced. Paragraph 6.14 of the GAS/SA Audit Guide encourages auditors to "take advantage" of the Uniform Guidance requirement to plan tests for a low assessed level of control risk of noncompliance (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 and correct, material misstatements or noncompliance in those assertions. The GAS/SA Audit Guide, Paragraph 11.61, explains that the auditor may vary the type or amount of evidence obtained about the effectiveness of individual controls based on the control's significance. All controls that the auditor determines are to be tested to mitigate the risk of material noncompliance are significant controls, but there is a spectrum of significance. The potential magnitude of noncompliance (both qualitatively and quantitatively) if the control were to fail is an important consideration in determining the significance. 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 compliance 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.

The GAS/SA Audit Guide, Paragraph 11.29, states that the type of audit procedure used to obtain audit evidence about a control's operating effectiveness is influenced by the nature of the control. For example, documentation of a control's operation might not exist for some factors in the control environment, such as assignment of authority and responsibility. The auditor might obtain audit evidence about operating effectiveness in these circumstances by performing inquiry in combination with other procedures such as observation.

Step 2—Considering Whether Testing Controls Is Practical

The Uniform Guidance requires the auditor 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 also considers 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 readily 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, performing tests of controls when sampling is used necessitates many decisions and actions by the auditor besides determining the type of test procedure.

Define the Population, Sampling Unit, 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 GAS/SA Audit Guide, Paragraph 11.42, states that if the auditor chooses to combine the transactions of multiple major programs into a single population and the sample that is selected does not include items from each major program, the auditor generally would judgmentally add additional items from any major programs from which items were not selected. Alternatively, the auditor could plan the initial sample in such a way that it includes items from each major program. For example, if there are three major programs of similar size and the auditor decides a sample of 60 items is appropriate for the test of controls, the auditor might select 20 items from each of the major programs. If the major programs are not similar in size, the sample could be allocated proportionately.

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 the expected performance of the prescribed controls.

The auditor has additional matters to consider when defining sample units if an entity has operations in multiple organizational units (e.g., operating units, locations, or branches). In this situation, controls might be centrally maintained or each organizational unit might maintain separate control for the programs, or parts of programs that it administers. The auditor needs to consider whether it is possible to obtain sufficient appropriate audit evidence by selecting one overall sample across the organizational units (for example, selecting from centralized locations or visiting all organizational units).

Determine the Tolerable Rate of Deviation. The tolerable deviation rate is the maximum rate of deviation from a prescribed control that the auditor is willing to accept without altering the planned assessed level of control risk of noncompliance. Determining the appropriate tolerable deviation rate is strictly an audit decision. What the use of 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? The GAS/SA Audit Guide, Paragraph 11.67, explains that to plan for low control risk of noncompliance (i.e., a high level of assurance), an auditor often uses a risk of overreliance of 10% or less with a tolerable deviation rate of 10% or less. There is an inverse relationship between the significance of a control and the auditor's tolerable deviation rate—as the significance of a control increases, the tolerable deviation rate decreases. In assessing the tolerable deviation rate, the auditor might consider that even though deviations from specific controls increase the risks of material noncompliance, such deviations do not always result in noncompliance.

Determine the Allowable 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.

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 needs to allow for a low level of risk of overreliance (i.e., sampling risk). The AICPA Sampling Guide (Paragraph 3.40) explains this point as follows:

> Because a test of controls is the primary source of evidence about whether they are operating effectively, the auditor planning to rely on controls generally sets a low risk that the controls will be assessed as more effective than they actually are (that is, a low risk of overreliance).

The auditor who prefers to think of risk levels in quantitative terms might consider, for example, a 5 percent to 10 percent risk of overreliance." Typically, the risk level is fixed at 10% in practice. This means there is 90% assurance that the auditor is not overrelying on controls. A planned 10% sampling risk means the auditor wants 90% assurance that the actual rate of deviation in the population does not exceed the specified tolerable rate and is willing to accept a 10% risk that it does. A 10% sampling risk is allowed because the auditor never places complete reliance on the control risk assessment.

Determine the Expected Rate of Deviations. The auditor also considers the expected rate of deviation from a particular control. If the expected rate is over one-half the tolerable rate, sampling may not be efficient. However, if the expected rate is high, the auditor would not plan to assess control risk below the high level. In practice, auditors performing tests of controls using sampling 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% risk of overreliance.

Determine the Sample Size. In a single audit, the size of the sample for a test of controls over compliance depends on the significance of the control being tested and the inherent risk of the compliance requirement. The Uniform Guidance requires the auditor to plan the audit to support a low level of assessed control risk for the assertions relevant to the compliance requirements for each major program. This requires the auditor to plan to obtain a high level of assurance that controls operate as designed. Exhibit 2-2 presents suggested minimum sample sizes for a population of 250 items or greater (Table 1) and less than 250 items (Table 2). The suggested sample sizes are based on Paragraph 11.59 of the GAS/SA Audit Guide and are designed to provide a high level of assurance.

The suggested minimum sample sizes in Exhibit 2-2 are designed to provide sufficient appropriate audit evidence that controls over compliance are operating effectively in many testing situations. As indicated by the table, a sample size of 25 can support a low control risk of noncompliance assessment for a population of at least 250 items for controls that are moderately significant and have limited inherent risk, as long as the auditor's tests find no deviations. However, larger sample sizes may be warranted, for example, if there are additional risks such as the design of the control or personnel operating the control have changed, or the auditor expects deviations.

Exhibit 2-2

Tests of Controls Sampling Table—90% Confidence Level

Table 1

Tests of Controls Sampling Tables—Population: 250 or Greater Minimum Sample Sizes—90% Confidence Level[a]

Significance of Control[b]	Inherent Risk of Noncompliance for Compliance Requirement[c]	Tolerable Rate	Expected Deviations		
			0	1	2
Very significant	Higher inherent risk	3–4%	60	100	138
Very significant	Limited inherent risk	5–7%	40	68	93
Moderately significant	Higher inherent risk	5–7%	40	68	93
Moderately significant	Limited inherent risk	8–10%	25	43	59

Table 2

Tests of Controls Sampling Table—Population: Less Than 250[c] Minimum Sample Sizes—90% Confidence Level[a]

Significance of Control[b]	Inherent Risk of Noncompliance for Compliance Requirement	Tolerable Rate	Expected Deviations		
			0	1	2
Very significant	Higher inherent risk	3–4%	51	83	111
Very significant	Limited inherent risk	5–7%	37	62	83
Moderately significant	Higher inherent risk	5–7%	37	62	83
Moderately significant	Limited inherent risk	8–10%	23	40	55

Notes:

[a] The tables are designed to provide a high level of assurance related to controls (that is, low control risk of noncompliance). They provide suggested minimum sample sizes for very and moderately significant controls and limited to higher inherent risk of material noncompliance. If testing discovers the same or fewer deviations than expected, then a high level of assurance is achieved that the control is being performed at an acceptable level to be effective. When more deviations are encountered than were planned for, the planned audit objective was not met.

[b] Paragraph 11.61 of the GAS/SA Audit Guide states, "All controls that the auditor determines are to be tested to mitigate the risk of material noncompliance are significant controls, but a spectrum exists concerning the significance of each control." Because minimum sample sizes differ (due to different desired confidence levels and tolerable deviation rates), information gathered by performing risk assessment procedures should be used when determining which controls are very significant or moderately significant. Determining the significance level of a control is discussed below.

[c] Paragraph 11.87 of the GAS/SA Audit Guide states that "for populations between 52 and 250 items, a rule of thumb some auditors follow is to test a sample size of approximately 10% of the population, but the size is subject to professional judgment, which would include specific engagement risk assessment considerations."

* * *

Significance of Control. Paragraph 11.61 of the GAS/SA Audit Guide states:

> All controls that the auditor determines are to be tested to mitigate the risk of material noncompliance are *significant controls*, but a spectrum exists concerning the significance of each control. [Emphasis added]

Because minimum sample sizes vary based on the desired confidence levels and tolerable deviation rates, the auditor should use his or her risk assessment to assist in determining which controls are very significant or moderately significant. The higher and more pervasive the risk relating to a given control objective (i.e., the "what could go wrong" risk), the greater the need for assurance on relevant preventive and detective controls to achieve a specific control objective, and the more likely it is that the auditor will assess greater significance for the related controls.

The auditor might consider several factors in determining the significance level of a control including whether the program is identified as higher risk in the Compliance Supplement and the potential magnitude of noncompliance (both qualitatively and quantitatively) to the program if the control were to fail. For example, if payroll is a large portion of the expenditures (in volume or dollars, or both) for a program, then the major controls related to payroll more likely would be considered very significant. However, if payroll is not a large portion of expenditures, the controls might be considered moderately significant or possibly not significant to the program.

A control might be considered moderately significant if there are complementary, compensating, or redundant controls. The auditor should obtain evidence regarding the effectiveness of such controls if the planned level of testing assumes reliance on them. Although this would result in multiple controls being tested for operating effectiveness, each control could be tested as a moderately significant control.

Inherent Risk of Noncompliance. AU-C 935.11 defines *inherent risk of noncompliance* as "the susceptibility of a compliance requirement to noncompliance that could be material, either individually or when aggregated with other instances of noncompliance, before consideration of any related controls over compliance." Paragraph 11.65 of the GAS/SA Audit Guide provides the following factors that might indicate a program has higher inherent risk of noncompliance:

- The program is new with little history.
- The program's maturity (i.e., life cycle phase) at the entity (for example, the program is in its first or last year).
- The program's maturity (i.e., life cycle phase) at the federal agency (for example, a new program with new or interim regulations).
- Outside parties provide goods or services related to compliance (for example, a third party disburses funds or determines eligibility).
- The program's complexity.
- The program involves judgment or complex processing (for example, nonroutine versus routine, nonsystematic versus systematic, manual versus programmed).
- Material weaknesses or significant deficiencies in internal control over compliance were identified in the past.
- Correspondence from program officials indicates potential problems.
- The entity did not adhere to applicable federal statutes, regulations, or the terms and conditions of federal awards in prior years.
- The entity experienced high employee turnover in a particular area.
- The program has a very high volume of activity.

- There has been a substantial change in the policies, processes, or personnel associated with the compliance requirement.
- There have been significant changes in federal statutes, regulations, or the terms and conditions of the federal award.
- The OMB has identified the program as higher risk.

The presence of one or more of the factors may result in the auditor determining that there is higher inherent risk of noncompliance. However, the auditor would use professional judgment to determine whether the number and combination of factors pose higher or limited inherent risk of material noncompliance. The size of the program does not necessarily affect the potential for noncompliance.

Sample Size for Very Small Populations. Some significant controls or instances of complying with a compliance requirement occur infrequently (for example, controls over submitting a required report). Exhibit 2-3 provides minimum sample sizes for infrequently operating controls over compliance when the population is very small. The suggested sample sizes are the same as those provided in Paragraph 11.86 of the GAS/SA Audit Guide.

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 appropriate sample size for more significant controls might be on the larger end of the ranges provided in the sample size table for small populations in Exhibit 2-3. The GAS/SA Audit Guide uses a population of fewer than 250 items to define a small population for the table. Paragraph 11.87 of the GAS/SA Audit Guide explains that for populations between 52 and 250 items, some auditors, as a rule of thumb, sample approximately 10% of the population; however, the auditor uses professional judgment, including consideration of specific engagement risk assessment, in choosing a sample size.

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 and Select the Sample

The sample selection methods described previously are appropriate for tests of controls using audit sampling. The GAS/SA Audit Guide, Paragraph 11.91, states that the auditor should select items for the sample in such a way that he or she can reasonably expect the sample to be representative of the relevant population and likely to provide a reasonable basis for conclusions about the population. (Paragraph 11.91 further states that the Compliance

Supplement provides specific guidance on selecting samples for certain types of major programs.) It cannot be over emphasized 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 documents necessary to perform the test are missing, the item normally should be counted as a deviation. AU-C 530.11 explains that an auditor should treat an item as a deviation from the described control (in the case of tests of controls) or a misstatement (in the case of tests of details) if he or she is unable to apply the planned audit procedures, or suitable alternative procedures, to a selected item.

This means that when a selected item is missing, the item should be treated as a deviation from the prescribed policy or procedure unless suitable alternative procedures can be performed. For example, if the auditor is testing for supervisory review and approval of invoices by inspecting selected invoices, and an invoice selected cannot be located, there is no documentary evidence the invoice was properly reviewed and approved, and it should be treated as a deviation. In the case of tests of controls, suitable alternative procedures generally are not available.

Another sampling consideration is whether the sample that was selected includes all of the attributes to be tested. The GAS/SA Audit Guide, Paragraph 11.38, explains that if the sample does not include an attribute being tested, the sampling population might not have been defined properly. In this situation, the auditor might consider keeping the original sample and adding other items that include the attribute which was originally excluded. The number of additional items to be considered is a matter of professional judgment.

The auditor needs to be sure that all of the significant controls relating to each direct and material compliance requirement for each major program identified are tested. The GAS/SA Audit Guide, Paragraph 11.42, states that when internal control for a type of compliance requirement (for example, eligibility) is common to more than one major program, the transactions of those programs may be combined into a single population for purposes of determining sample size and selecting the sample for tests of controls. If the sample that is selected does not include items from each major program, the auditor generally would judgmentally add additional items from any major programs from which items were not selected. Alternatively, the auditor may plan the initial sample in such a way that it includes items from each major program. For example, if there are three major programs of similar size and the auditor decides a sample of 60 items is appropriate for the test of controls, the auditor might select 20 items from each of the major programs. If the major programs are not similar in size, the sample could be allocated proportionately.

Step 5—Evaluating the Results of Tests of Controls

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. 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 tables in Exhibit 2-2 and Exhibit 2-3 may also be used for evaluation of sample results. When determining sample size, the auditor needs to judgmentally consider the risk that the population rate of deviations might be higher than the rate observed for the sample. For example, if the auditor wants to assess control risk of noncompliance as low for a population of 2,000 items and believes the sample results may include a single deviation, then a sample size of at least 100 would be necessary if the control is very significant and the compliance requirement has higher inherent risk. Conversely, a minimum sample of only 43 items is necessary if the control is moderately significant and the compliance requirement has limited inherent risk.

The GAS/SA Audit Guide, Paragraph 11.110, states that when evaluating sample results, the auditor should consider sampling risk, i.e., the risk that the auditor's conclusions based on a sample may be different from the conclusions if the entire population had been subjected to the same audit procedure. The auditor cannot simply compare the projected rate of deviation to the tolerable deviation rate and assess controls as effective if the projected rate is lower. The auditor should consider whether the same result would be obtained if the true deviation rate in the population is higher than the tolerable rate of deviation for the population.

Sampling risk may not be directly measurable in a nonstatistical sampling application; however, it is generally appropriate to conclude that the sample results do not support the planned assessed level of control risk of

noncompliance if the rate of deviation in the sample exceeds the expected population deviation rate used in designing the sample.

Paragraph 9.40 of the GAS/SA Audit Guide indicates that in situations where auditors cannot support a low assessed level of control risk of noncompliance for a direct and material compliance requirement for a major program, they are not required to expand their testing of internal control over compliance for that compliance requirement. Instead, they may choose not to perform additional tests of controls. It further indicates "in that situation, the auditor would assess control risk of noncompliance at other than low, design tests of compliance accordingly, and consider the need to report an audit finding". If auditors decide to expand their testing of internal control over compliance, their decision would be based on whether they consider the additional internal control testing to be more efficient than performing additional tests of compliance. Paragraph 9.42 of the GAS/SA Audit Guide notes that based on the testing performed, control risk of noncompliance might be assessed at less than maximum to reduce substantive tests of compliance. If it cannot be assessed at less than the maximum, it might be more appropriate to assess control risk of noncompliance at the maximum level.

It is natural for there to be some deviations in the way controls are applied. When deviations are detected during the performance of tests of controls, the auditor should make specific inquiries to understand the deviations and their potential consequences. In addition, the auditor should consider whether any noncompliance detected from performing substantive procedures changes his or her judgment about the effectiveness of the related controls. The auditor also should not assume that an instance of fraud or error is an isolated occurrence and should consider how it affects the assessed risk of material noncompliance.

The finding of more deviations than planned for in a sample is considered to be a non-negligible deviation rate because the auditor's desired confidence level was not obtained. According to Paragraph 9.55 of the GAS/SA Audit Guide, a control with a non-negligible deviation rate is at least a deficiency in internal control over compliance, regardless of the reason for the deviation. Further evaluation could result in the control deficiency being considered a significant deficiency or material weakness in internal control over compliance.

Because effective controls can reduce but not eliminate risks of material noncompliance, tests of controls can reduce but not eliminate the need for substantive procedures. Therefore, the auditor should design and perform substantive procedures for all relevant assertions related to the direct and material compliance requirements for each major program.

Paragraph 9.44 of the GAS/SA Audit Guide states that the results of tests of compliance should be considered when evaluating tests of controls. Detection of instances of noncompliance provides evidence about the ineffectiveness of the related internal control over compliance. Noncompliance detected by the auditor that was not identified by the entity may be an indicator of a material weakness or significant deficiency in internal control over compliance. However, the auditor cannot assume that controls related to a compliance requirement are effective if he or she does not detect noncompliance.

Calculating the Deviation Rate. Calculating the deviation rate involves dividing the number of observed deviations by the sample size. For example, if 3 deviations are detected in a sample of 60, the deviation rate is 5 percent ($^{3}/_{60}$). The sample deviation rate is also the auditor's estimated population deviation rate. If the estimated deviation rate is less than the tolerable rate, the auditor should consider the risk that might result if the true deviation rate in the population exceeds the tolerable rate. For example, if the tolerable deviation rate for a population is 5% and two or more deviations are found in a sample of 60 for a large population, the auditor might conclude that there is an unacceptably high sampling risk that the true rate of deviations in the population exceeds the tolerable rate.

The auditor should investigate the nature and cause of the deviations, such as whether they are due to noncompliance with federal statutes, regulations, or compliance requirements or due to error or fraud, and evaluate the possible effect on the purpose of the audit procedure and on other aspects of the audit. The GAS/SA Audit Guide, Paragraph 11.112, explains that, after considering the number of deviations and the reasons for them, the auditor might decide to either expand the test or to perform other tests that include sufficient additional items to reduce the control risk to an acceptable level. Instead of expanding the scope of testing, it is often more efficient in a single audit to report a deficiency in internal control over compliance, increase the assessed level of remaining risk of material noncompliance, and increase the extent of compliance testing to reflect the change in the control risk of noncompliance assessment.

The GAS/SA Audit Guide, Paragraph 11.103, explains that the sample is expected to be representative only with respect to the rate of deviations, not their nature or cause. An unexpected deviation may be indicative of other deviations in the population. If the auditor selects a small sample because the deviation rate is expected to be small or zero, but finds a deviation rate slightly higher than expected, it may be appropriate to extend the sample if the auditor believes that the observed deviation rate does not represent a reportable finding. However, the GAS/SA Audit Guide states that "the appropriate extension would not be small."

The nature and cause of a deviation might indicate that the deviation rate in the sample is not likely to be representative of the population (that is, it is not a systematic error). The auditor might consider performing additional procedures to determine whether the error is isolated to a specific subpopulation. To conclude that a deviation is nonsystemic generally requires the auditor to perform additional audit procedures to obtain sufficient appropriate audit evidence that the actual deviation rate of the sample is not representative of the population deviation rate.

Step 6—Assessing Control Risk of Noncompliance

Control risk of noncompliance is the risk that noncompliance with a compliance requirement that could occur and that could be material, either individually or when aggregated with other instances of noncompliance, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control over compliance. Essentially, assessing control risk of noncompliance involves applying the evaluation of the test (Step 5) to the assertions they were matched with in Step 1. AU-C 330.17 indicates that the auditor should determine whether the audit evidence obtained from the test of controls:

- provides an appropriate basis for reliance on the controls tested,
- indicates that additional tests of controls are necessary, or
- indicates the auditor needs to address the potential risks 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.

Step 7—Documenting Samples for Tests of Controls and Conclusions Reached

When using audit sampling for tests of controls, the auditor should consider the applicable documentation requirements in GAAS and the Yellow Book. AU-C 230.09 requires auditors to identify in the workpapers the identifying characteristics of the specific items tested. This requirement includes tests of the operating effectiveness of controls and substantive tests of details involving inspection of documents or confirmation, and inquiry and observation procedures. AU-C 530 does not impose specific documentation requirements for audit sampling, but the AICPA Sampling Guide (Paragraph 3.96) provides a listing of matters that auditors may document. 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.

AU-C 330.30 states that the auditor should document the nature, timing, and extent of the further audit procedures (the test of control in this instance); the linkage of those procedures to the assessed risks (control risk assessment) at the relevant assertion level; the results of those procedures; and conclusions reached. In addition, AU-C 935.39–.40 states that the auditor should document the risk assessment procedures performed, including procedures to obtain an understanding of internal control over compliance, and the auditor's responses to the assessed risks of material noncompliance, procedures performed to test compliance with the applicable compliance requirements, and the results of those procedures, including any tests of controls over compliance.

Documentation of sampling in a Uniform Guidance audit of compliance is influenced by several factors, including the size and complexity of the entity, the nature and complexity of the compliance requirements and of internal control over compliance, and the entity's past experience relative to compliance. A list of items the auditor typically documents for sampling in an audit of compliance was provided earlier in this lesson.

The lack of sampling documentation is one of the most common topics in letters of comments for peer reviews. Both AICPA standards (AU-C 230.08) 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, AU-C 230.09 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. AU-C 330.30 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.

To comply with the AU-C 230 requirements, the auditor's documentation of control tests should also include identification of the selected sample items. AU-C 230.A14 includes two examples of identifying specific items tested that the authors believe are relevant to tests of controls using sampling. One is to identify the documents selected for testing by their dates and document sequence numbers. The other applies when systematic selection is used; the auditor documents the source of documents, the starting point, and sampling interval.

Concluding on Tests of Controls. The auditor's overall conclusion about the effect of the results of the tests of controls on the assessed level of control risk of noncompliance, the risks of material noncompliance, and on the nature, timing, and extent of compliance tests requires professional judgment. The GAS/SA Audit Guide, Paragraph 11.114, states that if the sample results and other relevant audit evidence support the planned low assessed level of control risk of noncompliance, the auditor might not need to modify planned compliance tests. However, if the sample results do not support a low assessed level of control risk of noncompliance, Paragraph 11.114 notes that the auditor should consider either performing additional tests of other controls or increasing the assessed level of control risk of noncompliance and revising the nature, timing, or extent of the planned compliance tests accordingly.

Relating Compliance Audit Procedures to Financial Statement Audit Procedures

The components of a single audit include an audit of the financial statements and an audit of the federal award programs. 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.

The auditor could also consider how the testwork necessary for performing the compliance audit might contribute to the financial statement audit. For example, an entity may have one internal control process for handling payroll transactions. If the auditor tests the controls over payroll as part of the compliance audit, the auditor could consider that testwork when determining what additional tests of controls or other substantive procedures are necessary as part of the financial statement audit. The auditor may also choose to design tests of controls so that transactions from the entity's nonfederal program activities are selected for testing at the same time as the federal program transactions. As long as the compliance audit requirements are met, this method of testing may allow the auditor to be more efficient and maximize the audit evidence obtained from the tests of controls.

It can be challenging to select samples that achieve the objectives of both a Uniform Guidance compliance audit and a financial statement audit because there are different characteristics and appropriate populations for the two types of tests. For example, although federal award transactions are typically recorded in the general ledger, sampling populations used for financial statement audit purposes often do not align well with populations for testing in a compliance audit. The GAS/SA Audit Guide, Paragraph 11.57, gives as an example of a sample that achieves both compliance audit and financial statement audit objectives, a sample of transactions that is inspected to determine the following:

- Indications of compliance with relevant federal statutes, regulations, and compliance requirements for allowable costs and cost principles.

- Indications of performance of controls over both allowable costs and cost principles and the appropriateness of the expense for financial reporting.

- Evidence that the recorded amount, account, and period are correct for financial reporting.

The same principles described previously for dual purpose samples apply when a single sample is used to achieve both Uniform Guidance compliance audit and financial statement audit objectives. For example, it might be necessary to separately evaluate and document the two types of tests so that there is a clear distinction between the audit objectives and tests results.

Even if the financial statement and compliance parts of the audit are not conducted simultaneously, the auditor needs to consider the effects on the financial statement audit of any findings or questioned costs identified in the compliance audit. Likewise, the audit of the federal award programs may be able to take advantage of the results of audit procedures performed in auditing the entity's financial statements. 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 is needed when using 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.

17. Individual items that represent the components of the population and on which audit procedures are performed are called what?

    a. Control deviation.

    b. Individual transactions of interest.

    c. Monetary item.

    d. Sampling unit.

18. John is using audit sampling in his single audit engagement. His client has a cluster of programs. His initial sample does not include items relating to some of the important compliance requirements for specific programs in the cluster. Which consideration will help John determine whether his sample is representative of the cluster?

    a. The volume of transactions for the overall cluster.

    b. The consistency of processing controls over the different programs.

    c. The complexity of the transactions that occur within the cluster.

    d. The likelihood that his client will comply with requirements in the future.

19. Which of the following statements best describes the use of multi-purpose tests in single audits?

    a. The documentation for the objectives of multi-purpose tests can be combined.

    b. Dual-purpose tests can serve as a substantive test of account balances.

    c. A different sampling population is needed for each objective of a multi-purpose test.

    d. Control deviations may require a larger sample than planned for related compliance tests.

20. Which of the following programs is most likely to have a higher risk of noncompliance?

    a. Program 1 has been in existence for fifteen years.

    b. Program 2's compliance services are performed internally.

    c. Program 3 has a large number of manual transactions.

    d. Program 4 has the same people assigned to its compliance requirements for many years.

21. The following CPAs are performing single audit engagements that include sampling. Which auditor has correctly addressed an issue related to evaluating the results of tests of controls?

    a. Kara performed no additional tests of controls even though her control risk of noncompliance for a requirement is other than low.

    b. Dax does not consider sampling risk when evaluating results because he already considered it when planning his tests.

    c. Summer assumes that an error she found when performing her tests of controls is an isolated instance.

    d. Carlos omits substantive procedures because his tests of controls eliminate risk of 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.)**

17. Individual items that represent the components of the population and on which audit procedures are performed are called what? **(Page 373)**

    a. Control deviation. [This answer is incorrect. For tests of controls, a deviation is a departure from the expected performance of the prescribed control. This is a different concept than the one described above.]

    b. Individual transactions of interest. [This answer is incorrect. According to the GAS/SA Audit Guide, individually important items are those that, standing alone, are significantly different from the rest of the population, for example, increased activity around a certain time period such as journal entries made at the beginning or end of an award. They might be large, risky, or unusual items or transactions that contain characteristics of a prior compliance finding. This is a different type of item than the one described above.]

    c. Monetary item. [This answer is incorrect. In a single audit sampling application, the population may consist of monetary items. Examples of monetary items include all expenditures of a certain type for the entity or all expenditures of a certain type for all major programs. While the individual items described above could be monetary items, there is a better answer choice to fit that definition.]

    d. Sampling unit. [This answer is correct. The sampling units are the individual items that are subjected to audit procedures and that represent the components of the population. Examples of sampling units include individual subrecipient awards or contracts, award expense checks, payroll checks, etc.]

18. John is using audit sampling in his single audit engagement. His client has a cluster of programs. His initial sample does not include items relating to some of the important compliance requirements for specific programs in the cluster. Which consideration will help John determine whether his sample is representative of the cluster? **(Page 374)**

    a. The volume of transactions for the overall cluster. [This answer is incorrect. Per the GAS/SA Audit Guide, the volume of transactions and the size of expenditures for a particular program as a component of the overall cluster being tested needs to be considered, not the volume of transactions for the cluster as a whole.]

    b. The consistency of processing controls over the different programs. [This answer is correct. In the scenario above, John needs to use his professional judgment to determine what additional evidence he needs for his audit. Some factors he may consider in his determination are discussed in Paragraph 11.47 of the GAS/SA Audit Guide, such as the consistency of processing controls over the various programs in the cluster.]

    c. The complexity of the transactions that occur within the cluster. [This answer is incorrect. As described in the GAS/SA Audit Guide, John should consider the complexity of the compliance requirements when making this determination rather than the complexity of the transactions.]

    d. The likelihood that his client will comply with requirements in the future. [This answer is incorrect. According to the GAS/SA Audit Guide, one of the things John should consider in this situation is his client's past history of compliance, not the future likelihood.]

19. Which of the following statements best describes the use of multi-purpose tests in single audits? **(Page 377)**

    a. The documentation for the objectives of multi-purpose tests can be combined. [This answer is incorrect. Documentation for dual purpose tests needs to separately identify the two types of tests and the results of those tests. Not doing so has been noted as a negative finding in quality control reviews performed by federal agencies.]

b. Dual-purpose tests can serve as a substantive test of account balances. [This answer is incorrect. Dual-purpose tests include performing tests of controls that involve sampling simultaneously with tests of compliance with laws and regulations. A triple-purpose test may, in some instances, also serve as a substantive test of one or more account balances.]

c. A different sampling population is needed for each objective of a multi-purpose test. [This answer is incorrect. When using a dual-purpose sample for both internal control and compliance testing, it is important to align the objectives of the test to the same sampling unit and population so that the population from which the sample is selected is appropriate for the specific audit objectives.]

d. Control deviations may require a larger sample than planned for related compliance tests. [This answer is correct. Control deviations, including those relating to controls tested as part of a dual-purpose sample, present an increased risk of noncompliance and might necessitate a larger sample than originally planned for the related tests of compliance.]

20. Which of the following programs is most likely to have a higher risk of noncompliance? **(Page 384)**

a. Program 1 has been in existence for fifteen years. [This answer is incorrect. A program that is new and has little history is more likely to have a high risk of noncompliance, per the GAS/SA Audit Guide. Because Program 1 has been operating for a while, it should have enough history to help it avoid risk in this area.]

b. Program 2's compliance services are performed internally. [This answer is incorrect. According to the GAS/SA Audit Guide, when outside parties provide goods and services related to compliance, it will inherently have a higher risk of noncompliance. Therefore, Program 2 has a lower risk of noncompliance in this area.]

c. Program 3 has a large number of manual transactions. [This answer is correct. As described in Paragraph 11.65 of the GAS/SA Audit Guide, a program is more likely to have a higher risk of noncompliance when it involves judgment or complex processing. Because Program 3 has so many manual transactions (instead of programmed transactions), it will involve this type of judgment.]

d. Program 4 has the same people assigned to its compliance requirements for many years. [This answer is incorrect. If there has been a substantial change in the policies, processes, or personnel associated with the compliance requirement, it is more likely to have a high risk of noncompliance, as discussed in the GAS/SA Audit Guide.]

21. The following CPAs are performing single audit engagements that include sampling. Which auditor has correctly addressed an issue related to evaluating the results of tests of controls? **(Page 387)**

a. Kara performed no additional tests of controls even though her control risk of noncompliance for a requirement is other than low. [This answer is correct. Paragraph 9.40 of the GAS/SA Audit Guide indicates that in situations where auditors cannot support a low assessed level of control risk of noncompliance for a direct and material compliance requirement for a major program, they are not required to expand their testing of internal control over compliance for that requirement. Instead, they may choose not to perform additional tests of controls.]

b. Dax does not consider sampling risk when evaluating results because he already considered it when planning his tests. [This answer is incorrect. According to the GAS/SA Audit Guide, when evaluating sample results, the auditor should consider sampling risk, which Dax did not. The auditor cannot simply compare the projected rate of deviation to the tolerable deviation rate and assess controls as effective if the projected rate is lower. The auditor should consider whether the same result would be obtained if the true deviation rate in the population is higher than the tolerable rate of deviation for the population.]

c. Summer assumes that an error she found when performing her tests of controls is an isolated instance. [This answer is incorrect. The auditor also should *not* assume that an instance of fraud or error is an isolated occurrence and should consider how it affects the assessed risk of material noncompliance.]

d. Carlos omits substantive procedures because his tests of controls eliminate risk of material noncompliance. [This answer is incorrect. Because effective controls can reduce but not eliminate risks of material noncompliance, tests of controls can reduce but not eliminate the need for substantive procedures. Therefore, the auditor should design and perform substantive procedures for all relevant assertions related to the direct and material compliance requirements for each major program.]

SUBSTANTIVE TESTS OF COMPLIANCE

Compliance with federal statutes, regulations, and the terms and conditions of federal awards is necessary for an entity to recognize an amount as revenue earned or to receive reimbursement for an expense from an awarding agency. Therefore, compliance with federal statutes, regulations, and the terms and conditions of federal awards has a direct effect on line-item amounts in the financial statements of a governmental unit or nonprofit organization. Also, the Uniform Guidance 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.

Objective of the Tests

The primary objective of tests of compliance in a single audit is to determine whether the auditee has complied with federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on each of its major programs. A Uniform Guidance compliance audit results in the auditor expressing an opinion on the auditee's compliance with those compliance requirements for each of its major programs. To express such an opinion, the auditor gathers sufficient appropriate audit evidence by planning, performing risk assessment procedures, and performing tests of transactions and such other auditing procedures are necessary in support of the entity's compliance with direct and material compliance requirements.

Substantive Tests of Transactions

Substantive tests of transactions in a single audit usually relate to major program compliance with federal statutes, regulations, and the terms and conditions of federal awards. 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.

2 CFR section 200.514(d), describes the single audit requirement for the auditor to test compliance in order to determine whether the recipient has complied with federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on each major federal award program. (The definition of "major federal award program" and related matters were explained in Lesson 1.) Paragraph 6.14 of the GAS/SA Audit Guide addresses the opportunity for auditors to reduce substantive tests of compliance and increase audit efficiency because of the Uniform Guidance's control testing requirements, as follows:

> The Uniform Guidance requires the auditor to plan the testing of internal control over compliance and perform such testing to support a low assessed level of control risk of noncompliance for major programs. Therefore, when a low assessed level of control risk is achieved, the auditor may be able to take advantage of that low assessed level of control risk of noncompliance for major programs when performing the testing of compliance.

The auditor may be able to perform compliance testing for major programs concurrently with tests of controls (i.e., dual purpose testing). However, the controls 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.

Uniform Guidance Transition Considerations. Nonfederal entities (i.e., award recipients) have to implement the administrative requirements and cost principles in the Uniform Guidance for all new federal awards made on or after December 26, 2014, and for funding increments (additional funding on existing awards) with modified terms and conditions awarded on or after that date. Paragraph 6.77 of the GAS/SA Audit Guide explains that auditors should consider whether auditees may have updated or revised their internal control over compliance more than usual due to the implementation of the Uniform Guidance. Additionally, Paragraph 5.51 of the GAS/SA Audit Guide explains that auditors need to consider that major programs may include expenditures from federal awards subject to the pre-Uniform Guidance administrative requirements and cost principles, as well as federal awards subject to the Uniform Guidance administrative requirements and cost principles. This situation could remain for a number of years

until the awards subject to the pre-Uniform Guidance administrative requirements and cost principles have been completely expended. When testing major program transactions, it is important for the auditor to identify the date of the award related to a particular expenditure in order to determine the applicable criteria to use for the transaction being tested. However, it is not necessary to choose separate samples for testing.

Testing Individually Important Items

It may be possible to reduce the size of the sample or eliminate sampling altogether by first identifying and testing individually important items. Identifying individually important items for separate testing applies only to compliance testing and not to testing of internal control over compliance. When planning compliance testing, the auditor might identify for each major program a few large or unusual items that are individually important. (This is similar to the concept of individually significant items in a financial statement audit.) For example, if in testing the Allowable Costs/Cost Principles type of compliance requirement, there are a few very large expenditures, the auditor might consider these expenditures to be individually important. Individually important items might be identified through discussions with the auditee, applying analytical procedures, or using computer assisted auditing techniques. Individually important items are those that, standing alone, are significantly different from the rest of the population, for example, increased activity around a certain time period such as journal entries made at the beginning or end of a federal award. It is important to note that there are usually only a relatively small number of individually important items. Thus, a large number of transactions that make up a significant percentage of the dollars expended or that have a significant effect on compliance would not typically be considered individually important items. Paragraph 11.27 of the GAS/SA Audit Guide provides the following examples of individually important items and related compliance requirements:

- Transactions processed at the beginning or end of a federal award period. (Activities Allowed or Unallowed, Period of Performance)
- Transactions processed at odd times, such as new beneficiaries brought into a program in the spring if eligibility is usually awarded once a year during a fall enrollment period. (Eligibility)
- Program beneficiaries are near a qualifying age to receive benefits or have received multiple sources of funds. (Eligibility)
- Federal award close-out reports. (Reporting)
- Awards to subrecipients are unusually large compared with prior periods or with other subrecipients in the same program. (Subrecipient Monitoring)
- Transactions with subrecipients are new to the grantee, especially newly formed entities. (Subrecipient Monitoring)
- Transactions processed in foreign countries that may have higher risks such as foreign currency risk or different payroll and human resources issues and laws. (Activities Allowed or Unallowed, Subrecipient Monitoring)
- Transactions that, based on tests of internal control over compliance, are either not subject to controls or are not being processed appropriately. (various types of compliance requirements)
- A type of transaction that had findings in the past.
- Transactions related to a specific step in the Compliance Supplement, such as large transfers of funds from program accounts that may have been used to fund unallowable activities. (Activities Allowed or Unallowed)

Testing individually important items may result in a reduced sample size for the items remaining in the sampling population, or it might eliminate sampling altogether because it targets those items that have the greatest impact on noncompliance. For example, if 80% of a major program's expenditures could be examined by testing the ten largest expenditures, detection risk of noncompliance may be reduced enough that the level of assurance needed from a sample of the remaining 20% of untested items will be lower.

The GAS/SA Audit Guide, Paragraph 11.26, explains that it might not be efficient to identify individually important items when testing multiple types of compliance requirements at the same time. An item that is individually important item for one type of compliance requirement might not be individually important for another type of compliance requirement.

The auditor's documentation of individually important items should provide a clear understanding of the work performed, which may include the rationale, selection criteria, results of testing, and effect on the planned testing of the rest of the population.

When Is Audit Sampling Appropriate?

The Compliance Supplement identifies program requirements and suggests audit procedures for the 12 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 as previously discussed.

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. 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.

Terminology for Sampling in Tests of Compliance

The discussions in this lesson use the following sampling terms that are unique to compliance testing:

- *Exception*—Departure from federal statutes, regulations, and the terms and conditions of federal awards being tested.
- *Tolerable Exception Rate*—The maximum rate of compliance exceptions the auditor is willing to accept.
- *Expected Exception Rate*—The rate of exceptions the auditor expects in the population.

Designing the Sample

Paragraph 11.31 of the GAS/SA Audit Guide explains that when designing an audit sample, the auditor should consider the purpose of the audit procedure (e.g., to determine whether a necessary control was performed effectively or whether an expenditure was an allowable cost). Thus, to the extent each compliance test has a different purpose, samples would be separately considered.

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, Paragraph 11.92 of the GAS/SA Audit Guide explains that "it is preferable to select separate compliance samples from each major program because the separate samples provide 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, it is important for the audit documentation to clearly indicate that the results of such samples, together with other audit evidence, are sufficient to support the opinion on compliance for each major program.

Sample Size. Guidance on applying sampling in a Uniform Guidance audit of compliance is provided in Chapter 11 of the GAS/SA Audit Guide. In addition to providing important considerations for applying sampling in a Uniform Guidance audit of compliance, it provides suggested minimum sample sizes for tests of controls over compliance and tests of compliance. Paragraph 11.58 of the GAS/SA Audit Guide explains that sample sizes should be considered separately for internal control testing and compliance testing because the objectives for tests of controls and tests of compliance are different and have different factors to consider when determining sample sizes.

Factors That Affect Sample Size. 2 CFR section 200 states that the selection of transactions for testing should be based on the auditor's professional judgment considering such risk factors as the following:

- *Weaknesses in Internal Control over Federal Programs.* Weaknesses in internal control over compliance for federal programs would indicate higher risk [2 CFR section 200.519(b)(1)].
- *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 [2 CFR section 200.519(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 [2 CFR section 200.519(b)(1)(ii)].
- *Prior Audit Findings.* Prior audit findings relative to the program may indicate a higher risk, particularly when the situations identified in the audit findings could have a significant impact on the program or have not been corrected [2 CFR section 200.519(b)(2)].
- *Recent Audits.* Programs not audited as a major program recently may indicate a higher risk than federal programs recently audited as major programs without audit findings [2 CFR section 200.519(b)(3)].
- *Oversight by Federal Agencies and Pass-through Entities.* Recent monitoring or other reviews by federal agencies or pass-through entities that disclosed no significant problems would indicate lower risk. Recent oversight that disclosed significant problems would indicate higher risk [2 CFR section 200.519(c)(1)].
- *Complexity.* The more complex the program (eligibility, calculations, etc.), the higher the risk. The simpler the program, the lower the risk [2 CFR section 200.519(d)(1)].
- *Extent of Contracting.* The greater the amount of program contracting for goods and services, the higher the risk [2 CFR section 200.519(d)(1)].
- *Program Maturity at the Federal Agency.* The newer the program, the higher the risk. Also, significant changes in the federal programs, statutes, regulations, or the terms and conditions of federal awards may increase risk [2 CFR section 200.519(d)(2)].
- *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 [2 CFR section 200.519(d)(3)].
- *Size of Program.* The larger or smaller the amount of the award expended, the higher or lower the risk [2 CFR section 200.519(d)(4)].

These factors also affect the level of inherent risk that violation of statutes and regulations could have a material effect on major federal award programs. In assessing inherent risk of noncompliance, the auditor needs to also consider the results of other procedures performed as part of the audit of the financial statements.

Requirements for "Adequate" or "Representative" Number

The Uniform Guidance does not use the terms *adequate* or *representative* related to sampling. 2 CFR section 200.514(d)(4) indicates that compliance testing must include tests of transactions and other procedures to provide the auditor with sufficient appropriate audit evidence to support an opinion on compliance. The *OMB Compliance Supplement* (Compliance Supplement) uses the phrase "select a sample" or "test a sample." In addition, Paragraph 11.06 of the GAS/SA Audit Guide notes that auditors frequently use sampling to obtain audit evidence. It states:

> The auditor's compliance testing must include tests of transactions and such other auditing procedures necessary to provide the auditor with sufficient appropriate audit evidence to support the opinion on compliance for each major program. The auditor also must meet the requirements of the Uniform Guidance for testing and reporting on internal control over compliance. Sufficient

> appropriate audit evidence may be obtained through a variety of procedures, including planning and performing risk assessment procedures, performing tests of controls, performing tests of details (including tests of transactions), and other auditing procedures as are necessary. Auditors frequently use audit sampling procedures to obtain such audit evidence.

Report on National Single Audit Sampling Project. In June 2007, 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." Among other things, the Project considered testing and sampling in a number of the audits selected for quality control reviews. Among the report's findings was that inconsistent numbers of transactions were 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 response to the report, the AICPA now provides extensive guidance on single audit sampling in Chapter 11 of the GAS/SA Audit Guide. Sample size and sampling documentation are two key elements of that sampling guidance.

Selecting 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, in tests of compliance, each major program is usually considered to be a separate population because of the need to provide clear evidence of the compliance tests performed, the results of those tests, and the conclusions reached. If the auditor chooses to select the sample from a population consisting of multiple major programs, it is important to document how the results relate to each of the major programs and how that evidence, combined with other audit evidence, is sufficient to support the opinion on each major program's compliance.

The GAS/SA Audit Guide, Paragraph 11.37, states that the auditor should select items for the sample in such a way that he or she can reasonably expect it to be representative of the relevant population. If the sample that was selected does not include an attribute being tested, the auditor might consider keeping the original sample and adding other items that include the attribute which was originally excluded. The number of additional items to be considered is a matter of professional judgment.

Evaluating the Sample Results

AU-C 530.13 states, "The auditor should project the results of audit sampling to the population." The Uniform Guidance also requires the auditor to estimate the amount of likely questioned costs associated with audit findings. Projecting and evaluating sample results are discussed later in this lesson.

If the auditor determines that the projected amount of questioned costs is material to the individual program or that sampling risk is unacceptable, the auditor considers whether his or her opinion on compliance should be modified. The auditor's estimate of projected costs is also necessary to determine whether a finding needs to 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 needs to 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 next 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 discussed in the next section 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.

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 develops 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. 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.

A low combined inherent and control risk and other audit procedures generally results 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 would, 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.

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 performs 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.

Step 1—Assess the Tolerable Exception Rate. Generally, the tolerable exception rate is 5% for both monetary and nonmonetary compliance tests.

Step 2—Identify Individually Important Items. Individually important items are those that, standing alone, are significantly different from the rest of the population. The GAS/SA Audit Guide, Paragraph 11.21, explains that the auditor may use judgment to determine which items, if any, are individually important items that may be removed from the remaining population for separate testing. They might be large, risky, or unusual items or transactions that contain characteristics of a prior compliance finding. Individually important items are usually represented by only a relatively few items in a population. Examples of individually important items and related compliance requirements were presented earlier.

Exhibit 2-4

Steps for a Practical Approach to Planning the Extent of Substantive Procedures for a Single Audit

Step Description	Result
1. Assess the tolerable exception rate.	Tolerable exception rate (generally, a 5% exception rate for both monetary and nonmonetary tests of compliance). See the discussion later in this lesson.
2. Identify individually important items.	Identification of items to be tested 100%.
3. Calculate remaining balance after selecting individually important items.	Calculated balance for both monetary and nonmonetary attributes.
4. Determine what procedures, if any, are needed to test the remaining balance.	Procedures, if any, needed to test remaining balance.

* * *

Step 3—Calculate the Remaining Balance. After the individually important items have been selected, the remaining balance is computed. The remaining balance is calculated by subtracting the individually important items from the total population being tested.

Step 4—Consider Need to Apply Additional Procedures to the Remaining Balance. The auditor considers what procedures, if any, are needed to obtain sufficient audit evidence concerning the remaining balance. Generally, the following options are considered:

a. Determining that no additional audit procedures are needed.

b. Performing analytical procedures.

c. Performing other substantive procedures.

d. Applying audit sampling.

e. Expanding the audit procedures performed on individually important items.

The auditor may use a combination of these options with respect to the remaining balance.

The GAS/SA Audit Guide, Paragraph 11.19, explains that when individually important items do not make up the entire population, the auditor might apply audit sampling to the remaining items in the population. However, if there is an acceptably low risk of material noncompliance in the remaining items, the auditor might instead either apply other auditing procedures (such as scanning), or apply no auditing procedures. The auditor is not using sampling in these situations. Rather, the population has been divided into two groups, one which is tested 100%, and another which is either tested by other auditing procedures or is not tested.

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, as well as materiality (monetary and nonmonetary) at the major program and compliance requirement level. In assessing the risk of material noncompliance of the remaining balance, the auditor considers 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 important items and tests of controls. Using that knowledge, the auditor considers the nature, size, and frequency of noncompliance necessary for the remaining balance 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.

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 unless 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.

Performing Other Auditing Procedures. The auditor might apply other auditing procedures (such as analytical procedures or other substantive procedures) to the remaining items because there is an acceptably low risk of material noncompliance in the remaining items. In evaluating whether analytical procedures provide adequate evidence for the remaining balance, the auditor considers 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 other auditing procedures, (i.e., analytical procedures or other substantive procedures) do not provide sufficient appropriate audit evidence with respect to the remaining balance, then tests of details need to be applied to the remaining balance. Consequently, the auditor has two remaining options—using audit sampling or expanding the audit procedures performed on individually important items. In deciding between those options, the auditor considers the following factors:

a. *Number of Items in the Remaining Balance.* If the remaining balance consists of numerous items (such as 250 items or more), sampling generally is more efficient. However, if the auditor can further reduce the remaining balance by performing audit procedures on only a few additional individually important items or on a few of the larger items in the remaining balance, then it is probably more efficient to perform audit procedures on those items instead of sampling.

b. *Expected Noncompliance in the Remaining Balance.* For monetary tests of compliance, if the expected noncompliance in the remaining balance is high in relation to the tolerable exception rate and program or compliance requirement level materiality, 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. Similarly, in nonmonetary tests of compliance, the auditor should consider the expected noncompliance in the remaining balance.

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 Important Items. As discussed in the preceding paragraph, the auditor considers 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 important items normally is accomplished by choosing additional large, risky, or unusual items or transactions that contain characteristics of a prior compliance finding. After expanding audit procedures on individually important items, the auditor needs to determine whether sufficient appropriate evidence has been obtained to eliminate the need to sample the remaining balance.

The Importance of Identifying Individually Important Items

In planning, an auditor always needs to consider the audit evidence obtained by applying substantive procedures to individually important items or transactions. Because AU-C 530 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 those audit procedures 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 population between individually important items and items to be sampled.

Identification of individually important items is not required by the Uniform Guidance. However, there may be benefits of testing individually important transactions in specific populations. The GAS/SA Audit Guide, Paragraph 11.22, explains that examining a population for risky or unusual transactions might be more effective at identifying noncompliance than a randomly or haphazardly selected sample. This might also reduce detection risk of noncompliance because the sample size for the remaining items might be reduced or the need to sample may be eliminated altogether because items that have the greatest effect on noncompliance will have been tested. For example, if 80 percent of the total federal award expenditures can be examined by testing the largest 10 expenditures, detection risk of noncompliance may be reduced such that the level of assurance needed from a sample of the remaining 20 percent of untested items will be lower.

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 appropriate audit evidence with respect to the remaining balance and that audit sampling is appropriate, then the approach described in the rest of this section would be followed in applying audit procedures to the remaining balance.

The GAS/SA Audit Guide, Paragraph 11.76, indicates that the primary factor affecting the size of a sample for a particular compliance test is the risk of material noncompliance remaining after considering other audit procedures that were performed. The assurance (i.e., confidence level) needed from a sample and the minimum sample size depend on the risk of material noncompliance remaining after other audit procedures such as, risk assessment procedures, control testing, substantive analytical procedures, and tests of individually important items, have been performed. If tests of controls indicate that controls over compliance are effective and other audit procedures do not identify instances of noncompliance or specific heightened risk factors, it is likely the remaining risk of material noncompliance would be low or moderate. However, if the auditor concludes that controls are not operating effectively and a low assessed level of control risk of noncompliance for the major program cannot be supported, control risk of noncompliance should be assessed at the maximum. This may result in higher remaining risk of material noncompliance. The auditor's desired level of assurance from the compliance test would have to increase to moderate or high in order to support an unmodified opinion on compliance.

The desired confidence level from a sample can be different for different types of compliance requirements due to their varying degrees of importance and risk. In determining the desired confidence level from a sample, the auditor might consider the importance of the type of compliance requirement, inherent risk factors, fraud risks, the results from tests of the operating effectiveness of controls for the type of compliance requirement, and the results of procedures performed in the audit of the financial statements. The GAS/SA Audit Guide, Paragraph 11.80, indicates that several factors could affect inherent risk of noncompliance. It gives as examples, the regulatory environment, the significance of the requirement to the overall program, the complexity of relevant regulations, changes in regulations, or the auditee's experience with the program.

If the auditor concludes that controls over compliance are properly designed and operating effectively, the remaining risk of material noncompliance might be assessed as moderate or low and the desired level of assurance from

the sample reduced, resulting in a smaller sample size. Conversely, if tests of controls indicate that controls are not operating effectively and the auditor is not able to support a low assessed level of control risk of noncompliance for the major program, control risk of noncompliance should be assessed at the maximum. Maximum control risk of noncompliance might indicate a higher remaining risk of material noncompliance and the desired level of assurance from the compliance test would have to increase to moderate or high to support an unmodified opinion on compliance.

Because the auditor's opinion on compliance for each major program is based on the results of multiple procedures, it might not be necessary to design compliance samples to achieve high assurance when there are other sources of evidence beyond the compliance sample. The confidence levels associated with moderate and low in the compliance sample tables in this section are generally considered appropriate provided tests of controls and other audit procedures indicate that the remaining risk of material noncompliance is low.

Tolerable Exception Rate. The tolerable exception rate for compliance tests is the maximum rate of compliance exceptions that the auditor is willing to accept. It is related to program materiality for each major program and is a matter of professional judgment. Typically, it is equal to or less than the level of materiality for expressing an opinion on compliance. For example, if program materiality is 5% of program expenditures, then the tolerable exception rate for a compliance sample used for testing monetary attributes would be 5% or less. Similarly, if a 5% exception rate for a nonmonetary compliance attribute is considered material, then the tolerable exception rate for that nonmonetary attribute would be 5% or less. The sample size tables for compliance testing in this section use a 5% tolerable exception rate for both nonmonetary and monetary attributes.

Sample Size. The size of the sample depends on the remaining risk of material noncompliance after other audit procedures are performed, the auditor's tolerable exception rate, the desired assurance (confidence level) from the sample, and the expected number of exceptions. Exhibit 2-5 presents suggested minimum sample sizes associated with high, moderate, and low remaining risk of material noncompliance for a population of 250 items or greater (Table 1) and less than 250 items (Table 2). The suggested minimum sample sizes are based on Paragraph 11.72 of the GAS/SA Audit Guide.

Each type of compliance requirement to be tested should be evaluated separately for purposes of determining sample size. The suggested minimum sample sizes in Exhibit 2-5 may be used for each direct and material compliance requirement for each major program. Many audits of compliance will include a spectrum of sample sizes because some types of compliance requirements might present a high remaining risk of material noncompliance and would require a sample that provides high assurance, while other types of compliance requirements may present a low remaining risk of material noncompliance. Depending on the nature of the compliance requirement, the results of other audit procedures, and the risks and complexities of the sampling population, there might be situations when larger sample sizes would be more appropriate. For example, if there were significant deficiencies or material weaknesses noted with the related controls, the auditor might expand testing to support the conclusion on compliance.

Exhibit 2-5

Tests of Compliance Sample Table—5% Tolerable Exception Rate

Table 1

Tests of Compliance Sampling Table—Population: 250 or Greater Minimum Sample Sizes—5% Tolerable Exception Rate

Expected Number of Exceptions	Degree of Assurance Needed[a]		
	High (90–95% Confidence Level)	Moderate (87–89% Confidence Level)	Low[b]
0	60	40	25
1	91	71	53
2	120	98	76

Table 2

Tests of Compliance Sampling Table—Population: Less Than 250[c] Minimum Sample Sizes—5% Tolerable Exception Rate

Expected Number of Exceptions	Degree of Assurance Needed[a]		
	High (90–95% Confidence Level)	Moderate (87–89% Confidence Level)	Low[b]
0	51	37	25
1	78	63	48
2	101	85	[d]

Notes:

[a] The GAS/SA Audit Guide, Paragraph 11.71, explains that the assurance required (and, therefore, the determination of the minimum sample size) is directly related to the risk of material noncompliance remaining after other audit procedures (e.g., risk assessment procedures, controls testing, substantive analytical procedures, and tests of individually important items) have been performed. If tests of controls over compliance indicate that the controls are effective and other audit procedures do not identify noncompliance or specific heightened risk factors, it is likely the remaining risk of material noncompliance (and the degree of assurance needed) would be low or moderate. Conversely, if tests of controls over compliance identify deficiencies in the controls over compliance or if other audit procedures identify instances of noncompliance or specific heightened risk factors, it may lead the auditor to assess the remaining risk of material noncompliance as high or moderate.

[b] The sample sizes in this table for a low degree of assurance are based on the minimum sample sizes in Paragraph 11.72 of the GAS/SA Audit Guide. Those minimum sample sizes are based on a 5% tolerable rate and approximately a 75% confidence level. As discussed in Note a, the GAS/SA Audit Guide provides for choosing a sample size for a low degree of assurance provided the results of the auditor's tests of controls and other audit procedures indicate that the remaining risk of material noncompliance is low.

[c] Paragraph 11.87 of the GAS/SA Audit Guide states that "for populations between 52 and 250 items, a rule of thumb some auditors follow is to test a sample size of approximately 10 percent of the

population, but the size is subject to professional judgment, which would include specific engagement risk assessment considerations."

[d] Sampling would not be efficient in this situation because the large sample size would comprise a substantial part of the total population and the low confidence level associated with this degree of assurance.

* * *

Sample Size for Very Small Populations. Some significant instances of compliance do not occur frequently (for example, submitting a required report). Exhibit 2-3 provides minimum sample sizes for tests of infrequently operating controls. The suggested sample sizes in that exhibit are the same as those provided in Paragraph 11.86 of the GAS/SA Audit Guide for a compliance audit when testing compliance for a very small population. The appropriate sample size for more significant types of compliance requirements might be on the larger end of the ranges provided in the sample size table for small populations in Exhibit 2-5. The GAS/SA Audit Guide uses a population of fewer than 250 items to define a small population for the table. Paragraph 11.87 explains that for populations between 52 and 250 items, some auditors, as a rule of thumb, sample approximately 10% of the population; however, "the size is subject to professional judgment, which would include specific engagement risk assessment considerations."

Reducing Sample Size for Other Procedures Performed. 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 needs to be sure that all the applicable compliance requirements were tested for those five items.)

Selecting the Sample

Unlike in tests of controls, in tests of compliance each major program is usually considered to be a separate population. The GAS/SA Audit Guide, Paragraph 11.92, explains that "it is preferable to select separate compliance samples from each major program because the separate samples provide clear evidence of the tests performed, the results of those tests, and the conclusions reached, which support the auditor's opinion on compliance for each major program." Select a representative sample using one of the methods described previously in this lesson. The important point is that the auditor needs to ensure that all items in the population have a chance to be selected. Accordingly, the auditor needs to determine that the sample population actually includes all of the items comprising the balance and, if necessary, stratify the population and allocate the sample size to the specific groups.

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 Sample Results

The GAS/SA Audit Guide, Paragraph 11.116, explains that regardless of whether a sample is statistical or nonstatistical, "the auditor should evaluate the nature and cause of the noncompliance to reach an overall conclusion on compliance with a particular type of compliance requirement." Paragraph 11.118 further explains that because the auditor is required to determine likely questioned costs, it may be necessary to project the sample results when determining the effect on the auditor's opinion on compliance and whether a finding has to be reported. The Uniform Guidance does not require that the auditor expand the scope of a sampling application (i.e., test additional transactions) to definitely determine the total questioned costs. Instead, the auditor is only required to consider the effect of likely questioned costs on the compliance opinion and report an audit finding when the estimate of likely questioned costs exceeds $25,000. The auditor should document the noted exceptions (i.e., the questioned costs). If the known or likely questioned cost exceeds $25,000, the auditor must report the finding.

The focus of the compliance testing is on whether there is evidence of compliance to support the auditor's opinion on compliance. Although compliance testing often involves monetary amounts, the auditor also has to consider

nonmonetary compliance attributes (e.g., a report is submitted on a timely basis). The auditor should document exceptions noted in testing nonmonetary compliance attributes and consider whether the finding should be included in the Schedule of Findings and Questioned Costs (SFQC). The GAS/SA Audit Guide, Paragraph 11.117, explains that calculating the exception rate for a nonmonetary compliance test sample requires dividing the number of exceptions by the sample size. For example, three exceptions for a sample of 60 would result in an exception rate of 5% ($^3/_{60}$). The exception rate in the sample would generally be the auditor's best estimate of the exception rate in the population from which it was selected. The exceptions need to be evaluated to determine whether to report findings of material noncompliance and may affect the overall opinion on compliance.

The GAS/SA Audit Guide, Paragraph 11.120, explains that for monetary exceptions, two different approaches are commonly used to project questioned costs depending on the characteristics of the exceptions.

a. The first approach is used if the monetary exceptions are 100% errors (e.g., the entire sampling unit contains all unallowable costs) and are from a population of similar-sized transactions. In this circumstance, the technique used to determine nonmonetary exception rates can be used to estimate likely questioned costs. For example, if three exceptions are observed in a sample of 60, the exception rate is 5% ($^3/_{60}$). If the three exceptions were 100% errors and the population consisted of homogeneous transactions, the 5% exception rate would be applied to the total dollar amount of the population to estimate likely questioned costs. Thus, if the total value of the sampling population were $800,000, then the likely questioned costs would be $40,000.

b. The second approach relates the amount of questioned costs observed in the sample to the population. For example, if $2,000 of questioned costs are noted in a sample of expenditures that totaled $100,000, the questioned cost rate is 2% (2,000/100,000). If the total recorded amount in the expenditures population is $2,000,000, then projected likely questioned cost is $40,000 ($2,000,000 × 2%). This approach is particularly useful when a sampling unit is only partially incorrect.

If a compliance exception does not meet the criteria for reporting as a finding, the auditor would typically want to obtain assurance that the exception can be omitted from the schedule of findings and questioned costs (SFQC). While the Uniform Guidance does not require the auditor to expand the sample in the case of exceptions, the auditor might perform additional procedures to support the conclusion that the exception is not a finding. This might be the situation, for example, if the questioned costs are close to the reporting threshold of $25,000. In all cases where an initial exception is determined not to be a finding, the auditor should document the rationale for omitting the exception from the SFQC.

The GAS/SA Audit Guide, Paragraph 11.127, explains that a compliance exception indicates a potential deficiency in internal control over compliance. Thus, the auditor should relate exceptions from compliance testing to the results from the internal control testing when forming a conclusion about compliance and internal control over compliance.

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 has to consider the effect of questioned costs on the financial statements, that is, the need for the client 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. [Note that materiality for the compliance opinion is at the program level, whereas materiality for financial statement adjustment, disclosure, or report modification is at the financial statement level (opinion units). Thus, an instance of noncompliance or a questioned cost will not automatically be material to the financial statements.]

Considering Sampling Risk Associated with Compliance Testing

The GAS/SA Audit Guide, Paragraph 11.123, states that the auditor should give appropriate consideration to sampling risk when evaluating sample results from a test of compliance. If the estimated population exception rate (i.e., the sample exception rate) for nonmonetary attributes is less than the tolerable exception rate for the population, or if the estimate of likely questioned costs is less than the tolerable error for a monetary population, the auditor would consider whether a similar result might be obtained if the true exception rate or questioned costs for the population exceeds the tolerable rate or tolerable error, respectively, for the population. It is important to note

that smaller samples have greater uncertainty or sampling risk. The GAS/SA Audit Guide, Paragraph 11.124, explains that it is generally appropriate to conclude that the sample results do not support an acceptable level of compliance if the rate of exceptions or likely questioned costs in the sample exceeds the expected exception rate used in designing the sample.

If more compliance exceptions are identified than were planned for, the planned audit objective has not been met, and there is likely to be an unacceptably high risk that the true exception rate in the population exceeds the tolerable rate because of sampling risk. The GAS/SA Audit Guide, Paragraph 11.125, explains that after considering the number and magnitude of exceptions and the reasons for them, the auditor might decide to either expand testing or to perform other tests that include sufficient additional items to reduce the risk of material noncompliance to an acceptable level. However, instead of expanding the scope of testing, the auditor could choose to report the exceptions as an audit finding and evaluate the effect that the sample results have on the assessed level of risk of material noncompliance and the overall compliance opinion.

It is especially important to consider sampling risk when the projected likely questioned costs are close to $25,000 (i.e., the Uniform Guidance reporting threshold). In this situation, the auditor would usually conclude that there is an unacceptable risk that the true questioned costs exceed the reporting threshold. Even when the projected likely questioned costs are significantly less than the reporting threshold, the auditor should consider sampling risk (that is, the risk that a similar result might be obtained even though the actual questioned costs for the population exceed $25,000).

Evaluating Sample Results

The auditor's evaluation of the sample needs to be considered along with other relevant audit evidence when forming a conclusion about program compliance. As previously discussed, the auditor uses sampling when the items selected (the sample) are expected to be representative of the population and, thus, likely to provide a reasonable basis for conclusions about the population. 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 considers 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 needs to consider the overall effect on determining whether the program is or is not in compliance. The qualitative aspect of the instances of noncompliance are also considered. For example, the auditor considers 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 are considered when evaluating sample results. An auditor should also 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 Compliance Sampling Procedures and Conclusions Reached

Although AU-C 230, AU-C 530, and the GAS/SA Audit Guide do not impose specific documentation requirements for audit sampling, the standards require that audit documentation be sufficient to document that the applicable

GAAS have been observed. In other words, the audit documentation should show that AU-C 230 and AU-C 530 have been complied with. The lack of sampling documentation is one of the most common topics in letters of comments for peer reviews and findings in quality control reviews. AU-C 230.08 states that the audit documentation should be sufficient to enable an experienced auditor with no connection with the audit to understand:

- The nature, timing, and extent of auditing procedures performed to comply with GAAS and applicable legal and regulatory requirements (for example, *Government Auditing Standards* and the Uniform Guidance).
- The results of the audit procedures and the audit evidence obtained.
- Significant findings or issues, the conclusions reached on them, and significant professional judgments made in reaching the conclusions.

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.

In addition to the requirements of AU-C 230, AU-C 935.39–.40 states that the auditor should document the risk assessment procedures performed, including procedures to obtain an understanding of internal control over compliance, and the auditor's responses to the assessed risks of material noncompliance, procedures performed to test compliance with the applicable compliance requirements, and the results of those procedures, including any tests of controls over compliance.

Documentation of sampling in a Uniform Guidance audit of compliance is influenced by several factors, including the size and complexity of the entity, the nature and complexity of the compliance requirements and of internal control over compliance, and the entity's past experience relative to compliance. A list of items the auditor typically documents for sampling in an audit of compliance was provided earlier in this lesson.

SELF-STUDY QUIZ

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

22. Which of the following is most likely to be considered an individually important item when testing compliance?

    a. A transaction that occurs in the middle of a federal award period.

    b. A transaction related to a specific step in the Compliance Supplement.

    c. A transaction with effective internal controls.

    d. A transaction with one of the organization's typical subrecipients.

23. What is the first thing an auditor should do when planning the extent of substantive procedures for a single audit engagement?

    a. Assess the tolerable exception rate.

    b. Determine the procedures needed to test the remaining balance.

    c. Identify individually important items.

    d. Calculate the remaining balance.

24. In a nonmonetary compliance test sample of 80, there are 5 exceptions. What is the exception rate?

    a. 5%.

    b. 6%.

    c. 16%.

    d. Monetary exceptions have an exception rate; nonmonetary exceptions are treated differently.

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. Which of the following is most likely to be considered an individually important item when testing compliance? **(Page 396)**

    a. A transaction that occurs in the middle of a federal award period. [This answer is incorrect. According to the GAS/SA Audit guide, a transaction is more likely to be an individually significant item if it is processed at the beginning or end of a federal award period.]

    b. A transaction related to a specific step in the Compliance Supplement. [This answer is correct. Paragraph 11.27 of the GAS/SA Audit Guide provides examples of individually important items and related compliance requirements. One example of an individually important item is transactions related to a specific step in the Compliance Supplement, such as large transfers of funds from program accounts that may have been used to fund unallowable activities.]

    c. A transaction with effective internal controls. [This answer is incorrect. As discussed in the GAS/SA Audit Guide, a transaction is more likely to be considered individually important if, according to tests of internal control over compliance, it is either not subject to controls or is not being processed appropriately.]

    d. A transaction with one of the organization's typical subrecipients. [This answer is incorrect. Transactions with subrecipients that are new to the grantee, especially newly formed entities, are more likely to be individually significant items, per the GAS/SA Audit Guide.]

23. What is the first thing an auditor should do when planning the extent of substantive procedures for a single audit engagement? **(Page 401)**

    a. Assess the tolerable exception rate. [This answer is correct. This course outlines a practical approach for planning the extent of substantive procedures in a single audit. The first step in this process is for the auditor to assess the tolerable exception rate. Generally, the tolerable exception rate is 5%.]

    b. Determine the procedures needed to test the remaining balance. [This answer is incorrect. The fourth step in the process described in this course is to determine what procedures, if any, are needed to test the remaining balance.]

    c. Identify individually important items. [This answer is incorrect. Identifying individually important items is the second step of the planning process covered in this course.]

    d. Calculate the remaining balance. [This answer is incorrect. The third step for planning the extent of substantive procedures, as described in this course, is to calculate the remaining balance after individually important items have been selected.]

24. In a nonmonetary compliance test sample of 80, there are 5 exceptions. What is the exception rate? **(Page 406)**

    a. 5%. [This answer is incorrect. There were five exceptions; however, that is not the exception rate. Further calculations are needed.]

    b. 6%. [This answer is correct. The GAS/SA Audit Guide, Paragraph 11.117, explains that calculating the exception rate for a nonmonetary compliance test sample requires dividing the number of exceptions by the sample size. Therefore, in this scenario, the exception rate is calculated as follows: 5 / 80 = .0625. This would be rounded to 6%.]

c. 16%. [This answer is incorrect. This answer was calculated as follows: 80 / 5 = 16. However, this calculation does not match the one provided in the GAS/SA Audit Guide.]

d. Monetary exceptions have an exception rate; nonmonetary exceptions are treated differently. [This answer is incorrect. Exception rates are calculated differently for monetary and nonmonetary exceptions; however, a specific rate can be calculated for both using the guidance in the GAS/SA Audit Guide.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Single Audits—Course 3—Planning and Sampling for Single Audits (GSATG173)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This 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 the course, 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.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com**/**ogs** 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 of $89 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 email, mail, or fax your completed answer sheet, as described below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products; they can also be scanned for email grading, if desired. 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. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     GSATG173 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with 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 the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three 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 $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked by **September 30, 2018**. CPE credit will be given for examination scores of 70% or higher.

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) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Single Audits—Course 3—Planning and Sampling for Single Audits (GSATG173)

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. Which of the following is the operational approach to achieving the objectives of an audit?

    a. Risk assessment process.

    b. Audit program.

    c. Audit strategy.

    d. Risk assessment procedures.

2. Which of the following auditors has fulfilled the objectives of a single audit?

    a. James performs an audit of the financial statements, reports on the supplementary schedule of expenditures of federal awards, and performs a federal award compliance audit.

    b. Susan performs an audit of the financial statements and excludes the supplemental schedule of expenditures of federal awards.

    c. Mark performs a compliance audit of federal awards to ensure the client complies with all statutes and regulations, but does not audit the financial statements.

    d. Leslie disregards the entity's internal controls during her audit of financial statements, and concentrates on federal awards compliance.

3. Which of the following reports related to Federal Award Programs does the Uniform Guidance require in addition to the reports required by Government Auditing Standards?

    a. Opinion on whether financial statements are presented fairly in accordance with GAAP.

    b. Report on internal control over compliance.

    c. Report on internal control over financial reporting.

    d. Report on compliance with laws, regulations, grant agreements, and contracts.

4. A designated cognizant agency for an audit is necessary for what type of entity?

    a. Federal entity expending more than $50 million in lifetime awards.

    b. Nonfederal entity receiving annual awards over $100 million.

    c. Nonfederal entity disbursing over $50 million a year in federal awards.

    d. Nonfederal entity receiving any amount of federal awards.

5. Which of the following best describes communications with the cognizant or oversight agency for audit?

   a. The auditor is not allowed to communicate with the cognizant agency during the planning stage the single audit.

   b. Cognizant agencies for audits are instructed to contact auditees within 90 days of any reassignment.

   c. Cognizant agencies are required to approve the audit scope in advance of the audit.

   d. Auditors should document any communications with the cognizant agency in the audit workpapers.

6. Which of the following is true about clusters of programs?

   a. A cluster of programs is a grouping of closely related programs sharing common compliance requirements.

   b. By clustering certain programs, individual programs not meeting the major program criteria are less likely to be selected as major programs under the risk-based approach.

   c. Student financial aid programs are excluded from being in a cluster of programs by the Uniform Guidance.

   d. Programs identified as part of a cluster can be unclustered when determining major programs.

7. Normally state governments prescribe audit requirements under certain models for state grants expended. Which of the below is **not** one of these models?

   a. Single audit.

   b. Individual grant audits.

   c. Internal control audit.

   d. Individual agency audits.

8. David is auditing his client's state grant activity. What should David do for this type of engagement?

   a. David needs to determine whether AU-C 725 is applicable to the engagement.

   b. He should disregard any relationship of the state audit requirements to any federal requirements.

   c. He must determine the threshold for testing without input from the client or the state grantor agency.

   d. David should determine the nature of funding for audit costs.

9. Which of the following is true about federal pass-through awards?

   a. When combined in pass-through awards, both the nonfederal and federal portions are subject to the Uniform Guidance requirements.

   b. The state or other pass-through entity has the responsibility of notifying the client about the funding sources.

   c. If the state is unable to identify which portion is federally funded, all of the funds are excluded from the schedule.

   d. If a pass-through entity cannot properly identify the amounts passed through, the auditor should withdraw from the engagement.

10. Rick is an auditor performing risk assessment procedures. According to AU-C 315.05, what should Rick's procedures accomplish?

    a. They should provide a basis for assessment and identification of risks of material misstatement.

    b. They should be designed specifically as tests of controls and substantive procedures.

    c. They should provide sufficient appropriate evidence as a basis for his audit opinion.

    d. They should replace all audit procedures needed to support his opinion.

11. Which of the following auditors has correctly followed a procedure from Paragraph 3.47 of the GAS/SA Audit Guide to assess management's identification of compliance requirements and obtain an understanding of any possible effects on the financial statements?

    a. Mark disregards information from prior audits about compliance requirements in order to make his own assessments.

    b. Mary relies on reading prior audit notes rather than meeting with legal counsel and grant administrators.

    c. Rick reviews minutes of governing body meetings regarding new laws and regulations that may materially affect financial statements.

    d. Pam discusses compliance requirements with management rather than obtaining copies of laws and regulations that affect the client.

12. Which of the following is true about the identification of significant risks that require special audit consideration?

    a. Risks of material misstatement or noncompliance due to fraud are always considered significant risks.

    b. Risks of material misstatement or noncompliance due to error are always deemed significant risks.

    c. The degree of inherent risk does not help in determining or identifying significant risks.

    d. The AICPA Audit Guide states that, in most audits, it is unlikely for significant risks to arise.

13. What type of audit inquiry is required by AU-C 240.21?

    a. Inquiries of in-house legal counsel.

    b. Inquiries of those charged with governance.

    c. Inquiries of parties outside the entity.

    d. Inquiries of risk management personnel.

14. What is one topic that the engagement team for an audit is required to discuss regarding areas of vulnerability?

    a. Unusual accounting practices utilized by the client.

    b. Important control systems.

    c. Related-party relationships and transactions.

    d. Significant IT applications.

15. General planning in a single audit engagement should begin with obtaining knowledge and an understanding of the entity and its environment. Which of the following does **not** need to be documented by the auditor in relation to this understanding, according to AU-C 315.33?

    a. Participating audit team members.

    b. Sources of information for the understanding.

    c. Key elements of each aspect of the understanding.

    d. Risk assessment procedures performed.

16. Robert is an auditor evaluating fraud risk factors for a single audit engagement. Which of the following considerations applies to Robert's evaluation?

    a. When Robert identifies the presence of fraud risks he should only consider an overall response to the assessment of the risk of material misstatement.

    b. If there is no incentive or pressure to commit fraud, Robert should consider whether he can indicate in his report that the client is free from fraud risk.

    c. When considering risk factors for major program compliance, Robert should consider results of the financial statement fraud risk assessment to determine applicability.

    d. When considering risk factors for misappropriation, Robert should only consider asset susceptibility.

17. What should an auditor use as a base for determining and applying materiality levels during a single audit?

    a. The governmental audit requirement.

    b. The GAS/SA Audit Guide.

    c. The level of audit risk.

    d. Management recommendations.

18. Which of the following auditors has correctly applied the concept of materiality for a single audit?

    a. While designing her audit tests, Susan combined all major programs when applying the materiality concept.

    b. John applied the materiality concept to each major program when developing his opinion on compliance.

    c. Mark used 20% of total program awards expended to arrive at an appropriate materiality amount.

    d. Karen relied on only qualitative factors when determining if a noncompliance item had a material effect.

19. The risk that an auditor may unknowingly fail to appropriately modify an opinion of financial statements that are materially misstated is called which of the following?

    a. Sampling risk.

    b. Deviation.

    c. Risk of overreliance.

    d. Audit risk.

20. Which of the following statements accurately describes establishing an overall audit strategy for the single audit?

    a. It is a very detailed description of the audit procedures.

    b. The audit strategy is developed by the junior auditors on the audit team.

    c. It is the auditor's high level operational approach to achieving the audit objectives.

    d. Results of preliminary audit activities should not play a role in the overall audit strategy.

21. Which auditing standard provides guidance about the auditor's responsibilities for considering fraud risks and designing the audit to provide reasonable assurance of detecting fraud that could result in the financial statements being materially misstated that applies to a Uniform Guidance compliance audit?

    a. AU-C 240.

    b. AU-C 300.

    c. AU-C 315.

    d. AU-C 935.

22. Mike is working on an audit plan. What should he consider while developing this plan?

    a. His audit plan should be less detailed than his audit strategy.

    b. The plan should document procedures that will eliminate all audit risk.

    c. He should include a description of the nature and extent of planned risk assessment procedures.

    d. The audit plan cannot be updated or changed once the audit begins.

23. Which of the following items will **not** be included in the specific audit documentation required by AU-C 230?

    a. Report release date.

    b. Engagement letter date.

    c. Significant findings or issues.

    d. Identification of items tested.

24. Which of the following is true regarding the use of other auditors or third parties during a single audit engagement?

    a. Minority or women-owned firms are often engaged to perform portions of single audits.

    b. The Uniform Guidance prohibits the use of other auditors for single audit engagements.

    c. It is unnecessary to inform the client if outsourcing services to a third-party provider.

    d. Independent contractors used by a CPA do not meet the definition of third-party service providers.

25. Kay plans to use a client's internal auditors for direct assistance during her single audit engagement. What should Kay do before relying on their assistance?

    a. Obtain an oral agreement with the internal audit manager.

    b. Test and reperform all of their procedures to ensure accuracy.

    c. Exclude workpapers prepared by the internal auditors from the audit documentation.

    d. Assess the objectivity and competence of each internal auditor.

26. During a single audit, who is required to prepare appropriate financial statements and a schedule of expenditures of federal awards per 2 CFR section 200.508(b)?

    a. The auditee.

    b. The auditor.

    c. The engagement partner.

    d. The awarding government agency.

27. The GAS/SA Audit Guide provides guidance for audit sampling sizes. Which of these suggestions is correct?

    a. There is a required minimum sample size for a test of internal controls over compliance.

    b. For a test of compliance, the auditor must use the suggested sample size provided in the Guide's tables.

    c. The auditor may use professional judgment to determine a larger sample size than suggested is appropriate.

    d. The sample size for a dual purpose test should be the same as when the auditor did the tests separately.

28. What are the two possible approaches to audit sampling?

    a. Defining and selecting.

    b. Statistical and nonstatistical.

    c. Performing and evaluating.

    d. Tests of controls and substantive test of compliance.

29. John is selecting nonstatistical sample items using no specific pattern and without bias for or against any items in the sample population. What sample selection method is he using?

    a. Random selection.

    b. Systematic selection.

    c. Representative sample selection.

    d. Haphazard selection.

30. Which of the following is true when evaluating sample results?

    a. A statistical sample cannot be objectively measured.

    b. In a nonstatistical sample, sampling risk is objectively measured.

    c. The auditor should project the results of audit sampling to the population.

    d. A deviation that is systematic in nature in less likely to result in an audit finding.

31. What is the final step auditors should perform when they use audit sampling to test controls?

    a. Documenting the tests performed and conclusions reached.

    b. Performing tests of controls.

    c. Evaluating the results of the tests of controls.

    d. Selecting the appropriate tests of controls.

32. When controls operate infrequently, they have a small population size. What is the GAS/SA Audit Guide's suggested sample size for a control that operates weekly?

    a. 2.

    b. 2–4.

    c. 3–8.

    d. 5–9.

33. Which of the following accurately describes calculating the deviation rate?

    a. The sample size should be divided by the total population size.

    b. The auditor's estimated population deviation rate is different from the sample deviation rate.

    c. The number of observed deviations should be divided by the sample size.

    d. If five deviations are detected in a sample of 60, the deviation rate is 12%.

34. Ideally, how should an auditor approach the two components of a single audit engagement—auditing the financial statements and the federal award programs?

    a. To maximize efficiency when testing controls, the auditor can perform both audits simultaneously.

    b. To ensure accurate and independent results, the auditor should test transactions and controls of each component separately.

    c. The auditor should design the tests of controls to select transactions from the nonfederal activities separately from the federal transactions.

    d. The auditor can easily select samples that will achieve both the Uniform Guidance compliance audit objectives and objectives of a financial statement audit.

35. What is the primary objective of tests of compliance in a single audit?

    a. To determine if the entity has internal controls systems in place to provide reasonable assurance that it is managing federal award programs correctly.

    b. To determine if the auditee has complied with federal statutes, regulations, and the terms and conditions of federal awards that could have a direct and material effect on each of its major programs.

    c. To determine that the auditor has developed and performed audit procedures sufficient to conclude the population includes all transactions of interest for each audit objective.

    d. To determine if it is possible to reduce the size of the sample or eliminate all sampling by first identifying and testing important individual items.

36. Which term below is the maximum rate of compliance exceptions an auditor is willing to accept when using sampling in tests of compliance?

    a. Tolerable exception rate.

    b. Exception.

    c. Expected exception rate.

    d. Noncompliance rate.

37. Kim is selecting her sample for a test of compliance. What should Kim consider during this process?

    a. She is required to use a separate sample for each of the major programs tested.

    b. All major programs are combined into one population for compliance testing.

    c. She is required to obtain sufficient appropriate evidence to support her compliance opinion for each major program.

    d. She will not be allowed to add additional items to her sample selection once the original sample is selected.

38. Which of the following is true when planning the extent of substantive procedures in tests of compliance?

    a. Auditors are concerned with either the rate of noncompliance or the dollar value and should develop tests to address one of them.

    b. The Compliance Supplement specifies minimum sample sizes and exact selection methods an auditor should use.

    c. Sampling is always required even if the population is small and there is little inherent and control risk.

    d. A low combined control and inherent risk and other audit procedures usually results in a lower level of test work.

39. What is the suggested minimum sample size for a population size greater than 250 if the degree of assurance needed is low and the expected number of exceptions is 2?

    a. 25.

    b. 53.

    c. 76.

    d. 98.

40. In a Uniform Guidance audit, documentation of sampling is influenced by several factors. Which is **not** one of these factors?

    a. The attitudes and rationalizations for misappropriation of assets.

    b. The size and complexity of the entity.

    c. The complexity and nature of the compliance requirements.

    d. The entity's past experience relative to compliance.

GLOSSARY

Assertions: When performing an audit, assertions are what management is saying, either explicitly or implicitly, about the recognition, measurement, presentation, and discloser of information in the financial statements (or schedule of expenditures of federal awards) and related disclosures.

Audit plan: Also called the audit program, the audit plan documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence. It is more detailed than an audit strategy.

Audit risk: During a financial statement audit, it is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.

Audit risk of noncompliance: As defined by AU-C 935.11, it is the risk that the auditor expresses an inappropriate audit opinion on the entity's compliance when material noncompliance exists.

Audit strategy: 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, timing, and direction.

Cluster of programs: According to the Uniform Guidance, a cluster of federal programs is a grouping of closely related programs sharing common compliance requirements.

Component: A component may be an entity or business activity for which a group or component management prepares financial information that is required to be included in group financial statements.

Deviation: For sampling in tests of controls, this is a departure from the expected performance of the prescribed control.

Exception: For sampling in tests of compliance, this is a departure from federal statutes, regulations, and the terms and conditions of federal awards being tested.

Expected deviation rate: For sampling in tests of controls, this is the rate of deviations the auditor expects based on prior experience and knowledge of the characteristics of the population.

Expected exception rate: In sampling in tests of compliance, this is the rate of exceptions the auditor expects in the population.

Fraud risk factors: Events or conditions that indicate an incentive or pressure to perpetrate fraud, provide an opportunity to commit fraud, or indicate attitudes or rationalizations to justify a fraudulent action.

Material instance of noncompliance: For purposes of assessing compliance with laws and regulations, the GAS/SA Audit Guide defines this as a failure to comply with federal statutes, regulations, and the terms and conditions of the federal award that results in an aggregation of noncompliance that is material to the affected federal program.

Population: In sampling in tests of controls this is the class of transactions being sampled.

Report release date: This is the date the auditor gives the client permission to use the auditor's reports. For most audits, this will be the date the auditor delivers the report to the client.

Risk assessment procedures: Audit procedures performed to obtain an understanding of the entity and its environment including its internal control. In a single audit, it also includes an understanding of the entity's federal award programs, compliance requirements, and its internal control over compliance.

Risk of Overreliance: During tests of controls, this is the aspect of sampling risk that is the risk of erroneously concluding that the controls are more effective than they actually are. (This risk relates to audit effectiveness because the auditor who overrelies on controls inappropriately reduces the evidence obtained from substantive procedures.)

Sampling risk: In sampling in tests of controls, this is the risk that the auditor's conclusions based on sample may be different from the conclusions if the entire population had been subjected to the same audit procedure.

Sampling unit: The individual items that are subjected to audit procedures and that represent the components of the population when sampling in tests of controls.

Significant controls: All controls that the auditor determines must be tested to mitigate the risk of material noncompliance during sampling in tests of controls.

Third-party service providers: Entities that are not controlled by the member or member's firm and individuals who are not employed by a member or member's firms but who assist in providing professional services.

Tolerable deviation rate: When sampling in tests of controls, this is the maximum rate of deviation from a prescribed control that auditors are willing to accept without altering the planned assessed level of control risk of noncompliance.

Tolerable exception rate: During sampling in tests of compliance, this is the maximum rate of compliance exceptions the auditor is willing to accept.

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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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Please enter the number of hours it took to complete this course. _____

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:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. 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 cl.thomsonreuters.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 _____.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Single Audits—Course 2—Pre-engagement Activities and Internal Control Considerations (GSATG172)

Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____ Firm Fax No.: _____

Firm Email: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘.

You must complete the entire course to be eligible for credit.

	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.	○	○	○	○

You may complete the exam online for $89 by logging onto our online grading system at **cl.thomsonreuters.com/ogs**. Alternatively, you may fax the completed Examination for CPE Credit Answer Sheet and Self-study Course Evaluation to Thomson Reuters (Tax & Accounting) Inc. at (888) 286-9070 or email it to *CPLGrading@thomsonreuters.com*. Mailing instructions are included in the Exam Instructions. Payment information must be included for all print grading. The price for emailed or faxed answer sheets is $89; the price for answer sheets sent by regular mail is $99.

Expiration Date: September 30, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Single Audits—Course 2—Pre-engagement Activities and Internal Control Considerations

Course Acronym: GSATG172

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:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. _____

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:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. 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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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Single Audits—Course 3—Planning and Sampling for Single Audits (GSATG173)

Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____ Firm Fax No.: _____

Firm Email: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘.

You must complete the entire course to be eligible for credit.

	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: September 30, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Single Audits—Course 3—Plannning and Sampling for Single Audits

Course Acronym: GSATG173

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:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. _____

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.
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6. 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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