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

(Supersedes Statement on Auditing Standards No. 63, AICPA, Professional Standards, vol. 1, AU sec. 801.)

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Introduction and Applicability

1. This Statement establishes standards for testing and reporting on compliance with laws and regulations in engagements, as defined below, under generally accepted auditing standards (GAAS); *Government Auditing Standards*; the Single Audit Act of 1984 and Office of Management and Budget (OMB) Circular A-128, “Audits of State and Local Governments”; and OMB Circular A-133, “Audits of Institutions of Higher Education and Other Nonprofit Institutions.” It also addresses reporting on the internal control structure under *Government Auditing Standards*. Specifically, this Statement provides guidance on the auditor’s responsibility to—

- a. Apply the provisions of Statement on Auditing Standards (SAS) No. 53, *The Auditor’s Responsibility to Detect and Report Errors and Irregularities*, and SAS No. 54, *Illegal Acts by Clients*, relative to detecting misstatements resulting from illegal acts related to laws and regulations that—
 - Have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities (paragraphs 9 through 15).
 - Apply to governmental financial assistance and that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of nongovernmental entities (paragraphs 16 and 17).
- b. Report on compliance with laws and regulations and on the internal control structure in audits conducted in accordance with *Government Auditing Standards* (1988 revision), issued by the Comptroller General of the United States (paragraphs 20 through 42).¹

¹In practice, *Government Auditing Standards* is sometimes referred to as generally accepted government auditing standards (GAGAS) or the “Yellow Book.” *Government Auditing Standards* includes standards for financial audits as well as standards for performance audits. Among the matters that *Government Auditing Standards* addresses are quality control, continuing education, working papers, and audit follow-up. The references to *Government Auditing Standards* in this Statement encompass only the standards for financial audits, not the performance audit standards.

- c. Test and report on compliance with certain laws and regulations applicable to federal financial assistance programs in audits conducted in accordance with the federal Single Audit Act of 1984 and OMB Circular A-128 (paragraphs 43 through 92).²
- d. Test and report on compliance with certain laws and regulations applicable to federal award programs in audits conducted in accordance with OMB Circular A-133 (paragraphs 93 through 95).
- e. Establish an understanding with management regarding the type of engagement when engaged to test and report on program-specific audits or compliance with state or local laws and regulations (paragraphs 96 through 99).

2. Management is responsible for ensuring that the entity it manages complies with the laws and regulations applicable to its activities. That responsibility encompasses identifying applicable laws and regulations and establishing internal control structure policies and procedures designed to provide reasonable assurance that the entity complies with those laws and regulations. As this Statement explains, the auditor's responsibility for testing and reporting on compliance with laws and regulations varies according to the terms of the engagement.

3. Because of the variety of audit requirements to which entities receiving governmental financial assistance are subject, auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. If a proposal, contract, or engagement letter is used, an auditor may want to consider including in it a statement as to the type of engagement and whether the engagement is intended to meet a governmental oversight agency's audit requirements.

4. Management is also responsible for obtaining audits that satisfy relevant legal, regulatory, or contractual requirements. Generally accepted auditing standards do not require the auditor to perform procedures

²Certain single audit responsibilities are addressed in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* (fifth edition) and related AICPA Statements of Position and are therefore not addressed by this Statement. In addition, certain audit responsibilities under OMB Circular A-133 that are not addressed in this Statement will be addressed in a forthcoming AICPA Statement of Position. Appendix A to this Statement presents an overview of procedures and reports required in an audit conducted in accordance with the Single Audit Act and OMB Circular A-128 or in accordance with OMB Circular A-133.

beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. Therefore, if during a GAAS audit of the financial statements the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with generally accepted auditing standards may not satisfy the relevant legal, regulatory, or contractual requirements.³ For example, the auditor will be required to make this communication if an entity engages an auditor to perform an audit of its financial statements in accordance with generally accepted auditing standards and the auditor becomes aware that by law, regulation, or contractual agreement the entity also is required to have an audit performed in accordance with one or more of the following:

- *Government Auditing Standards*, issued by the Comptroller General of the United States
- The Single Audit Act of 1984 and OMB Circular A-128, “Audits of State and Local Governments”
- OMB Circular A-133, “Audits of Institutions of Higher Education and Other Nonprofit Institutions”
- Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

5. The communication required by paragraph 4 may be oral or written. If the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client’s actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor’s report on those financial statements. Specifically, the auditor should consider management’s actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54.

³For entities that do not have audit committees, “others with equivalent authority and responsibility” may include the board of directors, the board of trustees, the owner in owner-managed entities, the city council, or the legislative standing committee.

Compliance Auditing in Audits Conducted in Accordance With Generally Accepted Auditing Standards

6. In an audit performed in accordance with generally accepted auditing standards, the auditor's responsibility for consideration of laws and regulations and how they affect the audit is described in SAS Nos. 54 and 53. SAS No. 54, paragraph 5, equates the auditor's responsibility for detecting misstatements caused by certain illegal acts with the responsibility for other errors and irregularities:

The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. . . . However, the auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se. The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors and irregularities as described in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*.

7. SAS No. 53, paragraph 5, describes the auditor's responsibility for detecting errors and irregularities as follows:

The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.

8. Thus, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.⁴ This responsibility exists for all audits conducted in accordance with

⁴ Paragraph 5.5 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* (fifth edition) states that for general purpose financial statements "[e]xisting audit practice is that audit scope should be set and materiality evaluations should be applied at the fund type and account group level. . . ."

generally accepted auditing standards.⁵ Paragraphs 9 through 15 of this Statement address this responsibility in audits of the financial statements of governmental entities (including federal, state, and local entities). Paragraphs 16 and 17 address audits of the financial statements of other entities that receive financial assistance from a governmental entity. Paragraphs 18 and 19, respectively, address working papers and written representations from management.

Governmental Entities

9. The Governmental Accounting Standards Board's *Codification of Governmental Accounting and Financial Reporting Standards* (GASB *Codification*), section 1200.103, indicates that governmental entities generally are subject to a variety of laws and regulations that affect their financial statements:

An important aspect of GAAP [generally accepted accounting principles] as applied to governments is the recognition of the variety of legal and contractual considerations typical of the government environment. These considerations underlie and are reflected in the fund structure, bases of accounting, and other principles and methods set forth here, and are a major factor distinguishing governmental accounting from commercial accounting.

10. Paragraph 11 of this Statement provides guidance on obtaining an understanding of the possible effects on a governmental entity's financial statements of laws and regulations that have a direct and material effect on the determination of financial statement amounts. Paragraphs 12 through 15 provide guidance on considering the risk—including control risk—that the financial statements could include material misstatements resulting from violations of such laws and regulations.

Understanding the Effects of Laws and Regulations

11. The auditor should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in a governmental entity's financial statements.⁶ The auditor should also assess whether management has

⁵ The auditor undertakes the same responsibility in an audit of financial statements conducted in accordance with *Government Auditing Standards*.

⁶ Appendix B to this Statement presents examples of the possible effects of certain laws and regulations on a governmental entity's financial statements.

identified laws and regulations that have a direct and material effect on the determination of amounts in the governmental entity's financial statements. The auditor may consider performing the following procedures in assessing management's identification of such laws and regulations and in obtaining an understanding of their possible effects on the financial statements:

- a. Consider knowledge about such laws and regulations obtained from prior years' audits.
- b. Discuss such laws and regulations with the entity's chief financial officer, legal counsel, or grant administrators. Obtain written representation from management regarding the completeness of management's identification (see paragraph 19).
- c. Review the relevant portions of any directly related agreements, such as those related to grants and loans.
- d. Review minutes of meetings of the legislative body of the governmental entity being audited for the enactment of laws and regulations that have a direct and material effect on the determination of amounts in the governmental entity's financial statements.
- e. Inquire of the office of the federal, state, or local auditor or other appropriate audit oversight organization about laws and regulations applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.
- f. Inquire of the program administrators of the governmental entities that provided the grants about restrictions, limitations, terms, and conditions under which such grants were provided.⁷
- g. Review information about compliance requirements available from the state societies of CPAs or associations of governments.

Considering Risk

12. SAS No. 53, paragraph 9, states, "In developing an audit plan, the auditor should consider factors influencing audit risk that relate to

⁷ In assessing management's identification of requirements governing federal financial assistance programs and obtaining an understanding of their possible effects on the determination of financial statement amounts, the auditor may use as a reference source the *Compliance Supplement for Single Audits of State and Local Governments* and the *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions*, issued by the Office of Management and Budget, and the *Catalog of Federal Domestic Assistance*.

several or all account balances and obtain an understanding of the internal control structure.”

13. Factors influencing audit risk. SAS No. 53 cites matters the auditor should consider in assessing audit risk at the financial statement level and at the balance or class level. Certain of these matters are relevant to the auditor’s consideration of the risk of material misstatement of the financial statements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. For example, if a governmental entity is decentralized without adequate monitoring, the risk of material misstatement at the financial statement level might be increased. The risk of material misstatement related to particular assertions at the balance or class level might be influenced by the nature, cause, and amount of known and likely misstatements detected in prior audits and the competence of personnel assigned to processing data that affect the balance or class.

14. Internal control structure. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, requires the auditor to obtain an understanding of the internal control structure that is sufficient to plan the audit and to assess control risk for the assertions embodied in the financial statements. In an audit of the financial statements of a governmental entity, this understanding includes knowledge about the design of internal control structure policies and procedures relevant to financial statement assertions affected by compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts and about whether those policies and procedures have been placed in operation.⁹ In planning the audit, such knowledge should be used to identify types of potential misstatements, to consider factors that affect the risk of material misstatement, and to design substantive tests. The auditor’s assessment of control risk for assertions affected by compliance with such laws and regulations may be influenced by policies and procedures in all three

⁹In addition, for compliance with laws and regulations that have an indirect effect on the determination of financial statement amounts, SAS No. 54 notes that, where applicable, the auditor should also inquire of management concerning—

- The client’s policies relative to the prevention of illegal acts.
- The use of directives issued by the client and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations.

elements of the internal control structure (control environment, accounting system, and control procedures). For example, the following control environment factors may influence the auditor's assessment of control risk:

- a. Management's awareness or lack of awareness of applicable laws and regulations
- b. Entity policy regarding such matters as acceptable operating practices and codes of conduct
- c. Assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements

15. The auditor should consider whether any noted deficiencies in such internal control structure policies and procedures should be reported in accordance with SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*.

Other Entities That Receive Governmental Financial Assistance

16. Federal, state, and local governmental entities provide financial assistance to other entities, including not-for-profit organizations and business enterprises. Among the forms of governmental financial assistance are grants of cash and other assets, loans, loan guarantees, and interest rate subsidies.⁹ By accepting such assistance, both governmental and nongovernmental entities may be subject to laws and regulations that may have a direct and material effect on the determination of amounts in their financial statements. Such laws and regulations may deal with the following matters:

- a. *Types of services allowed or not allowed*—specifies the types of goods or services entities may purchase with financial assistance

⁹For purposes of this Statement, financial assistance, as defined by the Single Audit Act and OMB Circular A-128, does not include contracts to provide goods or services to a governmental entity or arrangements in which a nongovernmental entity purchases insurance from the government. Federal awards, as defined by OMB Circular A-133, means financial assistance and federal cost-type contracts used to buy services or goods for the use of the federal government. Federal awards do not include procurement contracts to vendors under grants or contracts used to buy goods or services. For example, financial assistance does not include a contract to design and manufacture aircraft for the U.S. Air Force or the purchase of deposit insurance by a financial institution. In addition, although Medicaid funds paid by the federal government to states are financial assistance, most Medicaid arrangements between the states and health-care providers are contracts for services that are not considered to be financial assistance.

- b. *Eligibility*—specifies the characteristics of individuals or groups to which entities may give financial assistance
- c. *Matching, level of effort, or earmarking*—specifies amounts entities should contribute from their own resources towards projects for which financial assistance is provided
- d. *Allowable costs/cost principles*—specifies principles and standards for determining costs applicable to federal financial assistance programs

17. The auditor's responsibility to detect material misstatements of financial statements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts is addressed in paragraphs 6 through 8 of this Statement. In carrying out this responsibility in an audit of the financial statements of a not-for-profit organization or a business enterprise that receives financial assistance from a governmental entity, the auditor should apply the guidance in paragraphs 11 through 15 that is relevant to that audit.

Working-Paper Documentation

18. The auditor should document procedures performed to evaluate compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 41, *Working Papers*. The auditor's understanding of the internal control structure as it pertains to compliance with such laws and regulations, as well as the related assessment of control risk, should be documented in accordance with SAS No. 55. (Page 4-6 of *Government Auditing Standards* includes additional working-paper requirements that the auditor should follow when engaged to perform an audit in accordance with those standards.)

Written Representations From Management

19. SAS No. 19, *Client Representations*, requires the auditor to obtain written representations from management as part of an audit conducted in accordance with generally accepted auditing standards. Among the matters ordinarily included in those representations are "violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency." In audits to which this Statement applies,

auditors should consider obtaining additional representations from management acknowledging that—

- a. Management is responsible for the entity's compliance with laws and regulations applicable to it.
- b. Management has identified and disclosed to the auditor all laws and regulations that have a direct and material effect on the determination of financial statement amounts.

Reporting Under *Government Auditing Standards*

20. A governmental entity, not-for-profit organization, or business enterprise may engage an auditor to audit its financial statements in accordance with *Government Auditing Standards*. In performing an audit in accordance with *Government Auditing Standards*, the auditor assumes responsibilities beyond those assumed in an audit conducted in accordance with generally accepted auditing standards to report on compliance with laws and regulations and on the internal control structure.¹⁰

Reporting on Compliance With Applicable Laws and Regulations

21. Paragraph 5 on page 5-2 of *Government Auditing Standards* includes the following requirement to report on compliance with laws and regulations:

The auditors should prepare a written report on their tests of compliance with applicable laws and regulations. This report, which may be included in either the report on the financial audit or a separate report, should contain a statement of positive assurance on those items which were tested for compliance and negative assurance on those items not tested. It

¹⁰ Concerning audit follow-up, paragraph 41 on page 3-16 of *Government Auditing Standards* states: "Due professional care also includes follow-up on known findings and recommendations from previous audits that could have an effect on the current audit objectives to determine whether prompt and appropriate corrective actions have been taken by entity officials or other appropriate organizations. . . . The auditor's report should disclose the status of known but uncorrected significant or material findings and recommendations from prior audits that [a]ffect the current audit objective."

should include all material instances of noncompliance, and all instances or indications of illegal acts which could result in criminal prosecution.

22. The auditor's report on compliance is based on the results of procedures performed as part of the audit of financial statements. Tests of compliance are discussed in paragraph 23 of this Statement. This Statement also discusses matters the auditor considers in reporting on compliance in accordance with *Government Auditing Standards*, as indicated below:

- a. Positive and negative assurance (paragraphs 24 through 26)
- b. Reporting noncompliance (paragraphs 27 through 30)
- c. Illegal acts (paragraphs 31 and 32)

Tests of Compliance With Applicable Laws and Regulations

23. Paragraph 6 on page 4-2 of *Government Auditing Standards* includes a requirement that "a test should be made of compliance with applicable laws and regulations." The auditor will have complied with the requirements of *Government Auditing Standards* by designing the audit to provide reasonable assurance of detecting errors, irregularities, and illegal acts resulting from violations of laws and regulations that have a direct effect on the determination of financial statement amounts that are material to the financial statements, as required by SAS No. 53 and SAS No. 54.

Positive and Negative Assurance

24. Paragraph 6 on page 5-2 of *Government Auditing Standards* states: "positive assurance consists of a statement by the auditors that the tested items were in compliance with applicable laws and regulations. Negative assurance is a statement that nothing came to the auditors' attention as a result of specified procedures that caused them to believe the untested items were not in compliance with applicable laws and regulations." The basic elements of a report expressing positive and negative assurance on compliance are—

- a. A statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the audit was conducted in accordance with generally accepted auditing standards and with *Government Auditing Standards* issued by the Comptroller General of the United States.

- c. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
- d. A statement that management is responsible for compliance with laws, regulations, contracts, and grants.
- e. A statement that, as part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, the auditor performed tests of compliance with certain provisions of laws, regulations, contracts, and grants.
- f. A statement that the objective of the audit of the financial statements was not to provide an opinion on overall compliance with such provisions and a disclaimer of opinion on compliance with laws, regulations, contracts, and grants.
- g. A statement of positive assurance that the results of the tests indicate that, with respect to the items tested, the entity complied, in all material respects, with the provisions of laws, regulations, contracts, and grants referred to in item e.
- h. A statement of negative assurance that, with respect to items not tested, nothing came to the auditor's attention that caused him or her to believe that the entity had not complied, in all material respects, with the provisions of laws, regulations, contracts, and grants referred to in item e.¹¹
- i. If applicable, a statement that certain immaterial instances of noncompliance were communicated to management in a separate letter.
- j. A statement that the report is intended for the information of the audit committee, management, and specific legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.¹²
- k. The manual or printed signature of the auditor's firm.
- l. The date of the auditor's report.

¹¹ In the event that instances of noncompliance are reported as a result of tests performed, the auditor should consider the extent to which the pervasiveness of reported instances of noncompliance may affect the auditor's ability to express negative assurance with respect to items not tested.

¹² *Government Auditing Standards* permits the auditor to combine the report on compliance with the report on the financial statements; if the auditor does so, the combined report should include a statement about its intended use.

25. The following is an example of an auditor's report on compliance when the auditor's procedures disclosed no material instances of noncompliance.

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

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

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

The results of our tests indicate that, with respect to the items tested, [name of entity] complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with those provisions.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. However, this report is a matter of public record and its distribution is not limited.¹³

[Signature]

[Date]

26. In rare circumstances, based on assessments of materiality and audit risk, auditors may decide not to perform any tests of compliance with provisions of laws, regulations, contracts, and grants. For example, an auditor may conclude that transactions and balances directly affected by laws and regulations are not material to the financial statements taken as a whole.¹⁴ In such circumstances, *Government Auditing Standards*, in paragraph 6 on page 5-2, states that "...the report should contain a statement that the auditor did not test for compliance with laws and

¹³ If the report is not part of the public record, this sentence should not be included in the report.

¹⁴ See footnote 4.

regulations.” The auditor’s report should not include a statement of positive assurance; however, the assessments of materiality and audit risk provide a basis for the auditor to conclude that the likelihood of material instances of noncompliance is low. These assessments are based, in part, on the procedures and considerations presented in paragraphs 11 through 15 of this Statement. Thus, the auditor has a basis for expressing negative assurance about compliance under *Government Auditing Standards*. The following is an illustration of the auditor’s report on compliance when, based on assessments of materiality and audit risk, the auditor concluded that it was not necessary to perform tests of compliance with laws and regulations.

[First two paragraphs are the same as in the report illustrated in paragraph 25.]

Compliance with laws, regulations, contracts, and grants applicable to [name of entity] is the responsibility of [name of entity]’s management. As part of our audit, we assessed the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants could cause the financial statements to be materially misstated. We concluded that the risk of such material misstatement was sufficiently low that it was not necessary to perform tests of [name of entity]’s compliance with such provisions of laws, regulations, contracts, and grants.

However, in connection with our audit, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with the laws, regulations, contracts, and grants referred to in the preceding paragraph.

[Fifth paragraph, signature, and date are the same as in the report illustrated in paragraph 25.]

Reporting Noncompliance

27. For purposes of this Statement, *material instances of noncompliance* are defined as failures to follow requirements, or violations of prohibitions, contained in statutes, regulations, contracts, or grants that cause the auditor to conclude that the aggregation of misstatements (that is, the auditor’s best estimate of the total misstatement) resulting from those failures or violations is material to the financial statements. When the auditor’s procedures disclose material instances of noncompliance, the auditor should modify the statements of positive and negative assurance included in the report. A qualified report should include—¹⁵

¹⁵ The auditor is not precluded from issuing an adverse report on compliance.

- a. The definition of material instances of noncompliance.
- b. An identification of material instances of noncompliance noted.¹⁶
- c. A statement that the noncompliance noted was considered in forming an opinion on whether the entity's financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

28. The auditor should report material instances of noncompliance regardless of whether the resulting misstatements have been corrected in the entity's financial statements. The auditor may wish to include a statement about whether the misstatements resulting from the material instances of noncompliance have been corrected in the financial statements or a statement describing the effect of such misstatements on his or her report on the basic financial statements. The following is an illustration of the auditor's report on compliance when material instances of noncompliance are identified.

[First three paragraphs are the same as in the report illustrated in paragraph 25.]

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in statutes, regulations, contracts, or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance, the effects of which have been corrected in *[name of entity]*'s 19X1 financial statements.

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

We considered these material instances of noncompliance in forming our opinion on whether *[name of entity's]* 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated *[date of report]* on those financial statements.

¹⁶ Pages 5-3 and 5-4 of *Government Auditing Standards* provide the following guidance on reporting material instances of noncompliance: "[T]he auditors should place their findings in proper perspective. The extent of noncompliance should be related to the number of cases examined to give the reader a basis for judging the prevalence of noncompliance. . . . In presenting the findings, the auditor should follow the report contents standards, as appropriate, for objectives, scope and methodology, audit results, and views of responsible officials, and the report presentation standards, discussed in chapter 7 [of *Government Auditing Standards*]."

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, [*name of entity*] complied, in all material respects, with the provisions referred to in the third paragraph of this report, and with respect to items not tested, nothing came to our attention that caused us to believe that [*name of entity*] had not complied, in all material respects, with those provisions.¹⁷

[*Last paragraph, signature, and date are the same as those illustrated in paragraph 25.*]

29. Page 5-3 of *Government Auditing Standards* includes the following provisions for reporting immaterial instances of noncompliance:

Other nonmaterial instances of noncompliance need not be disclosed in the compliance report but should be reported in a separate communication to the audited entity, preferably in writing. Such instances of noncompliance when communicated in a management letter to top management should be referred to in the report on compliance. All communications should be documented in the working papers.

30. If the auditor has issued a separate letter describing immaterial instances of noncompliance, the report prepared in accordance with paragraphs 24, 26, or 27 of this Statement should be modified to include a statement such as the following: “We noted certain immaterial instances of noncompliance that we have reported to the management of [*name of entity*] in a separate letter dated August 15, 19X1.”

Illegal Acts

31. As noted in paragraph 21, *Government Auditing Standards* requires the auditor to report instances or indications of illegal acts that could result in criminal prosecution. However, the auditor ordinarily does not possess the expertise to form a conclusion about whether an illegal act or possible illegal act could result in criminal prosecution. Thus, in complying with this requirement to report instances or indications of illegal acts that could result in criminal prosecution, the auditor may choose to report all illegal acts or possible illegal acts noted. (See paragraph 15, pages 4-4 and 4-5, of *Government Auditing Standards*, regarding consultation with legal counsel.)

32. Paragraphs 13 and 16 in chapter 5 of *Government Auditing Standards* provide the following guidance on reporting illegal acts:

¹⁷ See footnote 11.

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

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

Reporting on the Internal Control Structure

33. Consistent with SAS No. 60, the auditor should communicate any reportable conditions noted during the audit; however, reporting on the internal control structure under *Government Auditing Standards* differs from reporting under SAS No. 60.¹⁸ *Government Auditing Standards* requires a written report on the internal control structure in all audits; SAS No. 60 requires communication—oral or written—only when the auditor has noted reportable conditions. *Government Auditing Standards* requires a description of any reportable conditions noted, including identification of those that are considered to be material weaknesses. SAS No. 60 permits, but does not require, the auditor to separately identify and communicate as material weaknesses those reportable conditions that, in the auditor's judgment, are considered to

¹⁸ *Government Auditing Standards* states on page 5-6 that the requirement for a report "does not require any additional audit work other than that required as part of a financial audit. . . ."

be material weaknesses. Finally, *Government Auditing Standards* requires communication of the following matters, which are not addressed by SAS No. 60:

- a. Identification of the categories of the internal control structure
- b. Description of the scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing control risk
- c. Description of deficiencies in the internal control structure not considered significant enough to be reportable conditions

34. Paragraphs 35 and 36 of this Statement provide guidance on identifying elements of the internal control structure in the auditor's report, and paragraph 37 addresses reporting the scope of the auditor's work. Paragraphs 38 and 39 address the communication of "nonreportable conditions." Paragraphs 41 and 42 illustrate reports on the internal control structure.

Identifying Controls

35. Paragraph 17 on page 5-6 of *Government Auditing Standards* requires that the auditor's report on internal control structure related matters describe "...the entity's significant internal controls or control structure including the controls established to ensure compliance with laws and regulations that have a material impact on the financial statements..." *Government Auditing Standards* presents examples of different ways in which the internal control structure might be classified, noting that auditors may modify these examples or use other classifications as appropriate for the particular circumstances on which they are reporting.

36. Several variations are possible in the classifications presented in *Government Auditing Standards*. An entity might classify its transactions into a smaller or a larger number of classifications than mentioned in *Government Auditing Standards*. For example, the treasury or financing cycle might be classified as separate investments and debt cycles. For federal agencies, departments, and programs, the purchases/disbursements cycle might be subdivided into, among others, grants, loans, entitlements, payroll, and property and equipment; the revenue/receipts cycle might include taxes, duties, fines and licenses, sales of goods and services, and cash receipts. An entity might make its

classifications on an entity-wide basis or on a departmental basis at the local operating units.

Scope of the Auditor's Work

37. *Government Auditing Standards* requires that the auditor's report on internal control structure related matters describe the scope of his or her work in obtaining an understanding of the internal control structure and in assessing control risk. Auditors may satisfy this requirement by stating (a) that they obtained an understanding of relevant internal control structure policies and procedures and whether those policies and procedures have been placed in operation and (b) that they assessed control risk.

"Nonreportable Conditions"

38. Paragraph 25 on page 5-10 of *Government Auditing Standards* states:

Nonreportable conditions in an audited entity's internal control structure not included in the required reports, should be separately communicated to the audited entity, preferably in writing. Such control structure conditions when communicated in a management letter to top management should be referred to in the report on internal controls. All communications should be documented in the working papers.

39. To comply with this requirement, auditors should communicate to management the deficiencies in the internal control structure coming to their attention that they believe are not significant enough to be reportable conditions as defined in SAS No. 60. If the auditor has issued a separate written communication describing such "nonreportable conditions," the report prepared in accordance with paragraph 40 of this Statement should be modified to include a statement such as the following: "However, we noted other matters involving the internal control structure and its operation that we have reported to the management of [name of entity] in a separate letter dated August 15, 19X1."

Contents of Reports on the Internal Control Structure

40. When the auditor has noted reportable conditions in a financial statement audit conducted in accordance with *Government Auditing Standards*, the auditor's report on the internal control structure should contain—

- a. A statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the audit was conducted in accordance with generally accepted auditing standards and with *Government Auditing Standards* issued by the Comptroller General of the United States.
- c. A statement that, in planning and performing the audit of the financial statements, the auditor considered the entity's internal control structure in order to determine the auditing procedures for purposes of expressing an opinion on the financial statements and not to provide assurance on the internal control structure.
- d. A statement that the establishment and maintenance of the internal control structure are the responsibilities of management.
- e. An explanation of the broad objectives and inherent limitations of any internal control structure.
- f. A description of the entity's significant internal control structure policies and procedures, considered as part of the auditor's understanding of the structure.
- g. A description of the scope of the auditor's work, stating that the auditor obtained an understanding of the design of relevant policies and procedures, determined whether those policies and procedures have been placed in operation, and assessed control risk.
- h. The definition of reportable conditions.
- i. A description of the reportable conditions noted.
- j. The definition of material weakness.
- k. A statement about whether the auditor believes any of the reportable conditions described in the report are material weaknesses, and if they are, identifies the material weaknesses noted.
- l. If applicable, a statement that other matters involving the internal control structure and its operation were communicated to management in a separate letter.
- m. A statement that the report is intended for the information of the audit committee, management, and specific legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.

41. An example of such a report follows.

We have audited the financial statements of [*name of entity*] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

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

In planning and performing our audit of the financial statements of [*name of entity*] for the year ended June 30, 19X1, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of [*name of entity*] is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories [*identify internal control structure categories*].

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control

structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[Include paragraphs to describe the reportable conditions noted.]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of *[name of entity]* in a separate letter dated August 15, 19X1.

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record and its distribution is not limited.¹⁹

42. Paragraph 17 of SAS No. 60 prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. When the auditor notes no reportable conditions during an audit, he or she may issue a report, such as the following, to satisfy the requirements of *Government Auditing Standards*.

[First through sixth paragraphs of the report are the same as those illustrated in paragraph 41.]

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing

¹⁹ See footnote 13.

their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operation that we have reported to the management of [name of entity] in a separate letter dated August 15, 19X1.

[Last paragraph, signature, and date are the same as those illustrated in paragraph 41.]

Responsibilities Under the Single Audit Act

43. The Single Audit Act and OMB Circular A-128, “Audits of State and Local Governments,” which the Office of Management and Budget (OMB) issued to prescribe policies, procedures, and guidelines to implement the act, require state and local governments that receive total federal financial assistance equal to or in excess of \$100,000 in a fiscal year to have an audit performed in accordance with the Single Audit Act. The Single Audit Act states that a state or local government receiving at least \$25,000, but less than \$100,000, of total federal financial assistance in a year has the option of having an audit performed in accordance with either the act or with federal laws and regulations governing the programs in which the government participates. The Single Audit Act does not require state or local governments receiving less than \$25,000 in total federal financial assistance to have an audit performed.²⁰

44. The auditor should test and report on the following matters pertaining to compliance with laws and regulations:

- a. Compliance with laws and regulations that may have a material effect on the financial statements (see paragraphs 21 through 32 of this Statement)
- b. Compliance with general requirements applicable to federal financial assistance (paragraphs 46 through 52 address the general requirements)

²⁰ Auditors of colleges and other not-for-profit organizations that are not required to follow OMB Circular A-128 should follow OMB Circular A-133, “Audits of Institutions of Higher Education and Other Nonprofit Institutions,” which is patterned after Circular A-128. See paragraphs 93 through 95.

- c. Compliance with specific requirements that may have a material effect on each major program, as defined by the Single Audit Act (paragraphs 53 through 86 address the specific requirements)
- d. Compliance with certain laws and regulations applicable to nonmajor federal financial assistance programs (see paragraphs 87 through 90)

45. Among the other audit reports required by the Single Audit Act and OMB Circular A-128 are reports on the financial statements,²¹ on the supplementary schedule of federal financial assistance, and on internal control structure policies and procedures relevant to federal financial assistance programs.²² This Statement discusses the relationship between the work auditors do to form a basis for issuing those reports and the work auditors do to support their reports on compliance.

Compliance Auditing—General Requirements

46. The OMB's *Compliance Supplement for Single Audits of State and Local Governments*, which provides guidance for implementation of OMB Circular A-128, identifies nine "general requirements" that "involve significant national policy and for which failure to comply could have a material impact on an organization's financial statements including those prepared for federal programs. Accordingly, these compliance requirements shall be included as part of every audit of state, local, and Tribal government that involves [f]ederal financial assistance whether or not the government has a major program." The general requirements may or may not be laws and regulations that have a direct and material effect on the determination of financial statement amounts. Thus, the auditor should evaluate each general requirement based on the circumstances of the engagement to determine whether a particular requirement relates more to the laws and regulations described in SAS No. 54 that have an indirect effect on the financial statements than to those that have a direct and material effect on the determination of financial statement amounts.

²¹ If, after the date of the report on the audited financial statements, (a) the auditor performs other procedures as part of a single audit and (b) the results of those procedures indicate that facts may have existed at the date of the report on the audited financial statements that might have affected that report had the auditor then been aware of such facts, the auditor should follow AU section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report."

²² Appendix A to this Statement summarizes the procedures performed and reports issued in an audit in accordance with the Single Audit Act of 1984 and OMB Circular A-128 or OMB Circular A-133.

47. The general requirements deal with the following matters:²³

- a. *Political activity*—prohibits the use of federal funds for partisan political activity
- b. *Davis-Bacon Act*—requires that laborers working on federally financed construction projects be paid a wage not less than the prevailing regional wage established by the Secretary of Labor
- c. *Civil rights*—prohibits violation of anyone’s civil rights in a program funded by the federal government
- d. *Cash management*—requires recipients of federal financial assistance to minimize the time lapsed between receipt and disbursement of that assistance
- e. *Relocation assistance and real property acquisition*—prescribes how real property should be acquired with federal financial assistance and how recipients must help relocate people displaced when property is acquired
- f. *Federal financial reports*—prescribes federal financial reports that must be filed
- g. *Allowable costs/cost principles*—prescribes the direct and indirect costs allowable for federal reimbursement
- h. *Drug-free workplace*—prescribes that grantees certify that they provide a drug-free workplace
- i. *Administrative requirements*—prescribes administrative requirements (in addition to *d*, *f*, and *g*) that should be followed (Common Rule)

48. The *Compliance Supplement* suggests procedures for testing compliance with the general requirements. As the Single Audit Act and OMB Circular A-128 have been implemented, it has become generally accepted that the nature of these procedures is sufficient to satisfy the requirements of the act with respect to the general requirements. However, the *Compliance Supplement* does not specify the extent of such procedures. The auditor should exercise professional judgment in determining the extent of procedures for testing compliance with the general requirements, and may wish to obtain an understanding with the client about the extent of such procedures.

²³ Besides describing the general requirements, the *Compliance Supplement* includes references to the *Code of Federal Regulations* or other statutes where additional information about the requirements can be obtained. The auditor should consider referring to this information when planning to test compliance with the general requirements. The *Compliance Supplement* is revised periodically and, thus, the number of general requirements may change.

49. In performing an audit under the Single Audit Act and OMB Circular A-128, the auditor should issue a report on compliance with general requirements regardless of whether or not the government being audited has major programs. Determining the extent of any tests of compliance with the general requirements is a matter of professional judgment. Among the matters the auditor considers are the extent of any tests of controls over compliance with general requirements performed for major programs. If the government being audited has no major programs, the auditor should consider whether his or her tests of controls over compliance with general requirements provide evidence that would also support a report on compliance. If the tests of controls do not provide sufficient evidence to support a report on compliance, additional testing on the general requirements would need to be performed.²⁴

50. This Statement does not require the auditor to issue an opinion on compliance with the general requirements; rather, the auditor issues a report on the results of procedures used to test compliance with the general requirements.

51. The basic elements of a report expressing positive and negative assurance on compliance with the general requirements include—

- a. If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report
- b. A statement identifying the general requirements tested
- c. A statement that the auditor's procedures were limited to the applicable procedures described in the *Compliance Supplement* or that describes alternative procedures
- d. A statement that the auditor's procedures were substantially less in scope than an audit and a disclaimer of an opinion on compliance with the general requirements
- e. A statement of positive assurance that, with respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the general requirements

²⁴ Further guidance is provided in Statement of Position 90-9, *The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act*.

- f. A statement of negative assurance that, with respect to items not tested, nothing came to the auditor's attention that caused him or her to believe that the entity had not complied, in all material respects, with the general requirements²⁵
- g. A summary of all instances of noncompliance noted and identification of amounts questioned or reference to a separate schedule of findings and questioned costs (see paragraphs 77 through 79 of this Statement)
- h. A statement that the report is intended for the information of the audit committee, management, and specified legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record
- i. The manual or printed signature of the auditor's firm
- j. The date of the auditor's report

52. The following is an example of a report on compliance with the general requirements.

We have audited the financial statements of [*name of entity*] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

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

Our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Single Audits of State and Local Governments* [*or describe alternative procedures performed*]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of entity*]'s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of entity*] had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are

²⁵ See footnote 11.

described in the accompanying schedule of findings and questioned costs.²⁶

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.²⁷

[Signature]

[Date]

Compliance Auditing—Specific Requirements—Major Programs

53. The Single Audit Act states that the auditor “shall determine and report whether the government, department, agency, or establishment has complied with laws and regulations that may have a material effect upon each major federal assistance program.”²⁸ This Statement establishes that, to comply with this requirement, the auditor should perform auditing procedures designed to provide reasonable assurance of detecting material noncompliance with “specific requirements” applicable to major federal financial assistance programs and issue a report containing either an opinion on compliance with those requirements or a statement that such an opinion cannot be expressed (see paragraphs 55 through 86).

54. Auditors should consider the following matters in auditing and reporting on specific requirements:

- a. Identifying major federal financial assistance programs (paragraphs 55 and 56)
- b. Materiality in a compliance audit of major federal financial assistance programs (paragraph 57)

²⁶ If there are no instances of noncompliance, this sentence should be omitted.

²⁷ See footnote 13.

²⁸ A major federal financial assistance program is defined in terms of a government’s expenditure of federal financial assistance under that program relative to its total expenditures of federal financial assistance. (See the Glossary to this Statement for the definition of major federal financial assistance program.) OMB has published *Questions and Answers on the Single Audit Provisions of OMB Circular A-128, “Audits of State and Local Governments,”* which addresses such matters as the determination of whether federal assistance involving no expenditures, such as loan guarantees, constitutes a major program.

- c. Specific requirements applicable to a major federal financial assistance program (paragraphs 58 through 62)
- d. Components of the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on compliance (paragraphs 63 through 73)
- e. Subrecipient considerations (paragraphs 74 and 75)
- f. Evaluating results of audit procedures (paragraphs 76 through 79)
- g. Reporting on compliance with specific requirements (paragraphs 80 through 86)
- h. Management representations (paragraphs 91 and 92)

Identification of Major Federal Financial Assistance Programs

55. Management's responsibility for identifying federal financial assistance programs is established in the following requirement of OMB Circular A-128:

In order to determine which major programs are to be tested for compliance, [s]tate and local governments shall identify in their accounts all [f]ederal funds received and expended and the programs under which they were received. This shall include funds received directly from [f]ederal agencies and through other [s]tate and local governments.

56. The preparation of the schedule of federal financial assistance, required by OMB Circular A-128, is a means by which management identifies major and nonmajor federal financial assistance programs. In assessing the appropriateness of this identification, the auditor should consider, among other matters, evidence obtained from audit procedures performed in the audit of the financial statements, such as procedures performed to evaluate the completeness and classification of recorded revenues and expenditures.

Materiality

57. In auditing compliance with requirements governing major federal financial assistance programs in accordance with the Single Audit Act and OMB Circular A-128, the auditor's consideration of materiality differs from that in an audit of financial statements in accordance with generally accepted auditing standards. In an audit of an entity's financial statements conducted in accordance with generally accepted auditing standards, the auditor considers materiality in relation to the financial

statements.²⁹ In auditing an entity's compliance with requirements governing each major federal financial assistance program in accordance with the Single Audit Act and OMB Circular A-128, however, the auditor considers materiality in relation to each such program. When reaching a conclusion as to whether the effect of noncompliance, individually or in the aggregate, is material to a major federal financial assistance program, an auditor ordinarily should consider the nature of the noncompliance and the amount affected by it in relation to the nature and amount of the major federal financial assistance program under audit. For example, an amount that is material to one major federal financial assistance program may not be material to a major federal financial assistance program of a different size or nature. Also, what is material to a particular major federal financial assistance program might change from one period to another.

Identification of Specific Requirements Applicable to Major Programs

58. In performing an audit in accordance with the Single Audit Act and OMB Circular A-128, the auditor should test compliance with the specific requirements, as described below, that are applicable to major federal financial assistance programs. The auditor should obtain an understanding of those requirements that is sufficient to enable him or her to determine the nature, timing, and extent of procedures he or she will perform to provide a basis for expressing an opinion on compliance.³⁰ Specific requirements that, if not complied with, could have a material effect on a major federal financial assistance program generally pertain to the following matters:³¹

- a. *Types of services allowed or not allowed*, which specifies the types of goods or services entities may purchase with financial assistance
- b. *Eligibility*, which specifies the characteristics of individuals or groups to which entities may give financial assistance

²⁹ See footnote 4.

³⁰ The auditor would be precluded from issuing an opinion on compliance with a specific requirement if he or she concluded that management's assertion about compliance with that requirement is not capable of reasonably consistent estimation or measurement.

³¹ Certain of these requirements may have a direct and material effect on the determination of financial statement amounts. Thus, the auditor may wish to integrate his or her compliance audit of major federal financial assistance programs with work performed in the audit of the financial statements.

- c. *Matching, level of effort, or earmarking*, which specifies amounts entities should contribute from their own resources toward projects for which financial assistance is provided
- d. *Reporting*, which specifies reports entities must file in addition to those required by the general requirements
- e. *Special tests and provisions*, other provisions for which federal agencies have determined noncompliance could materially affect the program (for example, some programs require recipients to hold public hearings on the proposed use of federal financial assistance; others set a deadline for the expenditure of federal financial assistance)

59. Additionally, OMB Circular A-128 requires independent auditors to determine whether—

- [f]ederal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the basic financial statements have been prepared, and
- amounts claimed or used for matching were determined in accordance with OMB Circular A-87, “Cost Principles for State and Local Governments,” and OMB Circular A-102, “Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments.”

60. OMB Circular A-128 requires that the auditor’s report on compliance specifically address the requirements presented in paragraph 59.

61. The *Compliance Supplement* was issued by the Office of Management and Budget to assist auditors in performing single audits and supplements OMB Circular A-128. It describes compliance requirements specific to many of the larger federal financial assistance programs and suggests procedures for testing compliance with the specific requirements.³² Besides describing these specific requirements, the *Compliance Supplement* includes references to the *Code of Federal Regulations* and other sources of information about the requirements. The auditor should consider referring to these other sources of information in planning to test compliance with specific requirements.

³²In its *Questions and Answers on the Single Audit Provisions of OMB Circular A-128, “Audits of State and Local Governments,”* the OMB states that, for the programs contained in the *Compliance Supplement*, the audit of the requirements contained in the supplement will meet the requirements of OMB Circular A-128.

The auditor should also be aware that compliance requirements may change over time.

62. Major federal government programs not included in the *Compliance Supplement* may prescribe specific requirements governing financial assistance. To obtain an understanding of the specific requirements of the major programs not included in the *Compliance Supplement*, the auditor should consider reviewing the *Catalog of Federal Domestic Assistance* (hereafter referred to as the *Catalog of Assistance*). That publication, generally updated on an annual basis, contains all federal financial assistance programs, with citations to applicable laws and regulations associated with those programs. Also, the *Catalog of Assistance* contains names of program staff who serve as reference individuals for each program. The auditor may also wish to consider certain procedures described in paragraph 11 of this Statement that may be relevant to major programs.

Components of Audit Risk in a Compliance Audit of Major Programs

63. Audit risk—the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on compliance—is composed of inherent risk, control risk, and detection risk. For purposes of a compliance audit of major federal financial assistance programs, these components are defined as follows:

- a. *Inherent risk*—The risk that material noncompliance with requirements applicable to a major federal financial assistance program could occur, assuming there are no related internal control structure policies or procedures
- b. *Control risk*—The risk that material noncompliance that could occur in a major federal financial assistance program will not be prevented or detected on a timely basis by the entity's internal control structure policies and procedures
- c. *Detection risk*—The risk that an auditor's procedures will lead him or her to conclude that noncompliance that could be material to a major federal financial assistance program does not exist when in fact such noncompliance does exist

64. When considered together, the Single Audit Act and OMB Circular A-128 require the auditor to perform procedures that assess inherent and control risk and that restrict detection risk. The following paragraphs discuss the provisions of the Single Audit Act and OMB

Circular A-128 that pertain to each of these components of risk, provide guidance on applying those provisions, and explain how the components of risk interrelate in providing a basis for the auditor's opinion on compliance.

65. **Inherent risk.** Paragraph 8 of OMB Circular A-128 includes the following guidance, related to inherent risk, on determining the nature and extent of testing compliance with requirements that, if not complied with, could have a material effect on a major federal financial assistance program.

The selection and testing of transactions shall be based on the auditor's professional judgment considering such factors as the amount of expenditures for the program and the individual awards; the newness of the program or changes in its conditions; prior experience with the program, particularly as revealed in audits and other evaluations (e.g., inspections, program reviews); the extent to which the program is carried out through subrecipients; the extent to which the program contracts for goods or services; . . . the expectation of adherence or lack of adherence to the applicable laws and regulations; and the potential impact of adverse findings.

66. In assessing inherent risk, the auditor may also consider the results of any procedures performed as part of the audit of the financial statements, and of any tests of compliance with the general requirements.

67. **Control risk.** The Single Audit Act requires the auditor to determine and report whether the entity has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. Paragraph 8(a) of OMB Circular A-128 expands on this requirement.

The auditor must make a study and evaluation of internal control systems used in administering [f]ederal assistance programs. The study and evaluation must be made whether or not the auditor intends to place reliance on such systems. As part of this review, the auditor shall:

- (1) Test whether these internal control systems are functioning in accordance with prescribed procedures.
- (2) Examine the recipient's system for monitoring subrecipients and obtaining and acting on subrecipient audit reports.

68. These provisions of the Single Audit Act and OMB Circular A-128 encompass internal control structure policies and procedures relevant to an audit of an entity's compliance with the specific requirements,

discussed in paragraphs 58 through 62 of this Statement, applicable to major federal financial assistance programs.³³ Paragraphs 69 through 71 of this Statement discuss, in general terms, the auditor's consideration of these policies and procedures in an audit of compliance with requirements applicable to major federal financial assistance programs. Paragraphs 74 and 75 specifically address subrecipient considerations.

69. In satisfying the internal control provisions of the Single Audit Act and OMB Circular A-128, the auditor should obtain an understanding of the design of relevant internal control structure policies and procedures and whether they have been placed in operation. This understanding should be sufficient to plan the audit of compliance, enabling the auditor to—

- a. Identify the types of potential material noncompliance.
- b. Consider matters that affect the risk of material noncompliance.
- c. Design effective tests of compliance with requirements applicable to major federal financial assistance programs.

70. OMB Circular A-128's requirement to "test whether these internal control systems are functioning in accordance with prescribed procedures" involves performing tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material noncompliance. Procedures performed to obtain an understanding of the internal control structure may be considered tests of controls if they provide evidential matter about the effectiveness of the design and operation.

71. After obtaining an understanding of the internal control structure policies and procedures, the auditor should assess control risk. Assessing control risk contributes to the auditor's evaluation of the risk that material noncompliance exists in a major federal financial assistance program. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such noncompliance may exist. The auditor uses this evidential matter as part of the reasonable basis for the opinion on compliance.

³³The application of these provisions of the Single Audit Act and OMB Circular A-128 may also encompass internal control structure policies and procedures relevant to compliance with other requirements, including those applicable to nonmajor programs. Guidance on the application of these provisions, including guidance on reporting, is presented in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and related AICPA statements of position.

72. **Detection risk.** OMB Circular A-128 states that a compliance audit of major federal financial assistance programs should “include the selection and testing of a representative number of charges from each major [f]ederal assistance program.” Such compliance testing serves to restrict detection risk. In determining an acceptable level of detection risk, the auditor considers the level to which he or she seeks to restrict audit risk related to the major federal financial assistance program and the assessed levels of inherent risk and control risk. As the assessed level of control risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of compliance tests performed.

73. In determining the nature of his or her tests of compliance with requirements governing major federal financial assistance programs, the auditor should consider the nature of those requirements. For example, to test compliance with requirements applicable to the allowability of expenditures using program funds, audit procedures should be designed to provide the auditor with sufficient evidential matter to evaluate how management used the federal financial assistance. In designing compliance tests, auditors may wish to consider the procedures suggested in the *Compliance Supplement* for testing compliance with the requirements specific to many of the larger federal financial assistance programs.

Subrecipient Considerations

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

- a. Determine whether subrecipients have met the audit requirements of OMB Circular A-128 or OMB Circular A-133, whichever is applicable.
- b. Determine whether the subrecipient spent the federal financial assistance in accordance with applicable laws and regulations.
- c. Ensure that appropriate corrective action is taken within six months after receipt of a subrecipient’s auditor’s report that identifies noncompliance with federal laws and regulations.

- d.* Consider whether the results of subrecipients' audits indicate that the primary recipient should adjust its own records.
- e.* Require each subrecipient to permit independent auditors to have access to their records and financial statements as necessary to comply with OMB Circular A-128.

75. OMB Circular A-128 requires the primary recipient's auditor to evaluate the primary recipient's system for monitoring subrecipients. Although the primary recipient's auditor may be engaged to audit the subrecipients, neither the Single Audit Act nor OMB Circular A-128 requires the auditor to perform such an audit as part of the audit of the primary recipient.

Evaluating Results of Audit Procedures

76. In evaluating whether an entity has complied with laws and regulations that, if not complied with, could have a material effect on each major federal financial assistance program, the auditor should consider the effect of identified instances of noncompliance on each such program. In doing so, the auditor should consider—

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

77. The criteria for classifying a cost as a questioned cost vary from one federal agency to another. Many of the criteria were established by Congress when it authorized the programs and provided the funds; others were established through agency regulations. Generally, the criteria relate to the following:

- a.* Unallowable costs, or costs specifically not allowed under the general and special requirements or conditions of the program
- b.* Undocumented costs, or costs charged to a program for which detailed documentation does not exist
- c.* Unapproved costs, or costs for which the program requires approval

and the auditor cannot find evidence of approval, or costs not provided for in an approved budget

- d. Unreasonable costs, or costs incurred that may not reflect the actions of a prudent person, or the assignment of an unreasonably high value to in-kind contributions

78. In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned for each major federal financial assistance program (hereafter referred to as *likely questioned costs*), not just the questioned costs specifically identified (hereafter referred to as *known questioned costs*). When using audit sampling, as defined in SAS No. 39, *Audit Sampling*, in testing compliance, the auditor projects the amount of known questioned costs identified in the sample to the items in the major federal financial assistance program from which the sample was selected.

79. Regardless of the auditor's opinion on compliance, OMB Circular A-128 requires him or her to report any instances of noncompliance found and any resulting questioned costs. In reporting instances of noncompliance, the auditor should follow the provisions of paragraph 9 on page 5-3 of *Government Auditing Standards*. The auditor should relate the number of instances of noncompliance that resulted in known questioned costs to the number of transactions examined. For purposes of reporting questioned costs, neither the Single Audit Act nor OMB Circular A-128 requires the auditor to report likely questioned costs; rather, the auditor should report only known questioned costs.

Reporting on Compliance With Specific Requirements—Major Programs

80. The basic elements of the auditor's report on compliance with specific requirements include—

- a. If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the entity's compliance with the requirements identified in the report was audited.
- c. A statement that compliance with the requirements in item *b* is the responsibility of the entity's management and that the auditor's

responsibility is to express an opinion on compliance with those requirements based on the audit.

- d. A statement that the audit was conducted in accordance with generally accepted auditing standards; *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-128, "Audits of State and Local Governments."
- e. A statement that generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Circular A-128 require that the auditor plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to in item *b* occurred.
- f. A statement that an audit includes examining, on a test basis, evidence about the entity's compliance with the requirements referred to in item *b*.
- g. A statement that the auditor believes that his or her audit provides a reasonable basis for an opinion.
- h. A summary of all instances of noncompliance noted and identification of amounts questioned or reference to a separate schedule of findings and questioned costs.
- i. A statement that noncompliance or questioned costs noted were considered in forming an opinion as to whether the entity complied, in all material respects, with requirements referred to in item *b*.
- j. An opinion as to whether the entity complied, in all material respects, with the requirements referred to in item *b*.
- k. A statement that the report is intended for the information of the audit committee, management, and specific legislative or regulatory bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.
- l. The manual or printed signature of the auditor's firm.
- m. The date of the auditor's report.

81. The following is an example of an unqualified opinion of an entity's compliance with requirements that govern each major federal financial assistance program.

We have audited the financial statements of [*name of entity*] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We have also audited [*name of entity*]'s compliance with the requirements governing [*list specific requirements tested—see paragraphs 58 and 59*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1. The management of [*name of entity*] is responsible for [*name of entity*]'s compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-128, "Audits of State and Local Governments." Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about [*name of entity*]'s compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying schedule of findings and questioned costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.³⁴

In our opinion, [*name of entity*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.³⁵

[*Signature*]

[*Date*]

82. Auditors are able to express an unqualified opinion only if they have been able to apply all the procedures they consider necessary in the circumstances. Restrictions on the scope of their audit, whether imposed by the client or by circumstances such as the timing of the auditors' work, the inability to obtain sufficient competent evidential matter, or an

³⁴If there are no instances of noncompliance, this paragraph should be omitted.

³⁵See footnote 13.

inadequacy in the accounting records, may require auditors to qualify their opinion or to disclaim an opinion. In such instances, the reasons for such a qualification or disclaimer of opinion should be described in the auditor's report. Further, the auditor should consider the effects of such instances on his or her ability to express an unqualified opinion on the financial statements.

83. The auditor's decision to qualify or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on compliance with requirements governing each major federal financial assistance program. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to each major federal financial assistance program. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on compliance. The following is an example of an opinion qualified because of a scope limitation.

[First and second paragraphs of the report are the same as those illustrated in paragraph 81.]

Except as discussed in the following paragraph, we conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-128, "Audits of State and Local Governments." Those standards and OMB Circular A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about *[name of entity]*'s compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain sufficient documentation supporting *[name of entity]*'s compliance with the requirements of Major Program ABC governing types of services allowed or unallowed; nor were we able to satisfy ourselves as to *[name of entity]*'s compliance with those requirements of Major Program ABC by other auditing procedures.

[Fifth paragraph of the report is the same as the fourth paragraph of the report illustrated in paragraph 81.]

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding *[name of entity]*'s compliance with the requirements of Major Program ABC governing types of services allowed or unallowed,

[*name of entity*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

[*Last paragraph of the report is the same as the sixth paragraph of the report illustrated in paragraph 81.*]

[*Signature*]

[*Date*]

84. When disclaiming an opinion because of a scope limitation, the auditor should indicate in a separate paragraph(s) the reasons why his or her audit did not comply with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, or OMB Circular A-128. The auditor should state that the scope of his or her audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed or include a paragraph describing the characteristics of an audit (that is, the scope paragraph); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any reservations he or she has regarding compliance with applicable laws and regulations. The following is an example of a report disclaiming an opinion resulting from an inability to obtain sufficient competent evidential matter because of a scope limitation.

[*First paragraph of the report is the same as the first paragraph of the report illustrated in paragraph 81.*]

We were engaged to audit [*name of entity*]'s compliance with the requirements governing [*list requirements to have been tested*] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1. The management of [*name of entity*] is responsible for [*name of entity*]'s compliance with those requirements.

[*Third paragraph of the report illustrated in paragraph 81 should be omitted.*]

The management of [*name of entity*] has refused to provide us with written representations that generally accepted auditing standards require us to obtain.

Because of the matter described in the preceding paragraph, the scope of our audit work was not sufficient to enable us to express, and we do not express, an opinion on [*name of entity*]'s compliance with the requirements governing [*list requirements to have been tested*] that are

applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

[Last paragraph of the report is the same as the sixth paragraph of the report illustrated in paragraph 81.]

[Signature]

[Date]

85. When the audit of an entity's compliance with requirements governing a major federal financial assistance program detects noncompliance with those requirements that the auditor believes have a material effect on that program, the auditor should express a qualified or adverse opinion. The auditor should state the basis for such an opinion in the report. The following is an example of an auditor's opinion that is qualified because of noncompliance with requirements governing federal financial assistance.

[First three paragraphs of the report are the same as those illustrated in paragraph 81.]

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

[Fifth paragraph of the report is the same as the fourth paragraph of the report illustrated in paragraph 81.]

In our opinion, except for those instances of noncompliance with the requirements applicable to Major Program ABC referred to in the fourth paragraph of this report and identified in the accompanying schedule of findings and questioned costs, *[name of entity]* complied, in all material respects, with the requirements governing *[list requirements tested]* that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

[Last paragraph of the report is the same as the sixth paragraph of the report illustrated in paragraph 81.]

[Signature]

[Date]

86. Following is an example of an adverse opinion because of noncompliance with requirements governing federal financial assistance.

[First three paragraphs of the report are the same as those illustrated in paragraph 81.]

[Add a paragraph describing reasons for the adverse opinion.]

[Fifth paragraph of the report is the same as the fourth paragraph of the report illustrated in paragraph 81.]

In our opinion, because of the noncompliance referred to in the fourth paragraph, *[name of entity]* did not comply, in all material respects, with the requirements governing *[list requirements tested]* that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

[Last paragraph of the report is the same as the sixth paragraph of the report illustrated in paragraph 81.]

[Signature]

[Date]

Compliance Auditing—Specific Requirements—Nonmajor Programs

87. The Single Audit Act and OMB Circular A-128 require that “[t]ransactions selected from [f]ederal assistance programs, other than major [f]ederal assistance programs, . . . shall be tested for compliance with [f]ederal laws and regulations that apply to such transactions.” This requirement recognizes that, in connection with the audit of the financial statements or the consideration of the internal control structure over federal financial assistance programs, the auditor may have selected for testing transactions from federal financial assistance programs other than major programs. If the auditor has selected such transactions, they should be tested for compliance with the requirements that apply to the individual transactions.³⁶

88. Generally, the requirements for which compliance should be tested relate to the allowability of the program expenditure and the eligibility of the individuals or groups to which the entity provides federal financial assistance. For example, if in the audit of the financial statements an auditor examines a payroll transaction that was charged to

³⁶ If the auditor has not selected any nonmajor federal financial assistance program transactions, or if the entity has no nonmajor programs, no report describing that situation is required.

a nonmajor program, the auditor should determine whether the position could reasonably be charged to that program and whether the individual's salary was correctly charged to that program.

89. The basic elements of the auditor's report on compliance with requirements applicable to nonmajor federal financial assistance program transactions include—

- a. If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements including a description of any departure from the standard report.
- b. A statement identifying the requirements tested.
- c. A statement that the procedures for testing compliance with the specific requirements applicable to nonmajor federal financial assistance programs are required by OMB Circular A-128.
- d. A statement that these procedures were performed in connection with an audit of the financial statements and with the consideration of the internal control structure over federal financial assistance programs, as required by OMB Circular A-128.
- e. A statement that the auditor's procedures were substantially less in scope than an audit and a disclaimer of an opinion on compliance with the requirements identified.
- f. A statement of positive assurance that, with respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the specific requirements identified.³⁷
- g. A statement of negative assurance that, with respect to items not tested, nothing came to the auditor's attention that caused him or her to believe that the entity had not complied, in all material respects, with the specific requirements identified.³⁸
- h. A summary of all instances of noncompliance noted and identification of amounts questioned or reference to a separate schedule of findings and questioned costs.
- i. A statement that the report is intended for the information of the audit committee, management, and specified legislative or regulatory

³⁷ For purposes of reporting on compliance with requirements applicable to nonmajor federal financial assistance programs, the auditor should consider material noncompliance to be the same as "material instances of noncompliance," which is defined in paragraph 27 of this Statement.

³⁸ See footnote 11.

bodies, but that this is not intended to limit the distribution of the report, if it is a matter of public record.

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

90. Following is an illustrative report on the results of the tests of compliance with the requirements applicable to nonmajor federal financial assistance program transactions. (When the auditor issues a report on compliance for major federal financial assistance programs, these reports may be combined.)

We have audited the financial statements of [*name of entity*] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

In connection with our audit of the financial statements of [*name of entity*] and with our consideration of [*name of entity*]'s control structure used to administer federal financial assistance programs, as required by Office of Management and Budget Circular A-128, "Audits of State and Local Governments," we selected certain transactions applicable to certain nonmajor federal financial assistance programs for the year ended June 30, 19X1. As required by Circular A-128, we have performed auditing procedures to test compliance with the requirements governing [*list requirements tested*] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of entity*]'s compliance with these requirements. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of entity*] had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.³⁹

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.⁴⁰

[*Signature*]

[*Date*]

³⁹ If there are no instances of noncompliance, this sentence should be omitted.

⁴⁰ See footnote 13.

Written Representations From Management

91. The auditor should obtain written representations from management as part of an audit conducted in accordance with the Single Audit Act of 1984 and OMB Circular A-128. The following are specific written representations ordinarily obtained by the auditor:

- a. Management has identified in the schedule of federal financial assistance all assistance provided by federal agencies in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations.
- b. Management has identified the requirements governing political activity, the Davis-Bacon Act, civil rights, cash management, relocation assistance and real property management, federal financial reports, allowable costs/cost principles, drug-free workplace, and administrative requirements over federal financial assistance.
- c. Management has identified the requirements governing types of services allowed or disallowed; eligibility; matching, level of effort, or earmarking; reporting; *[include any special provisions]*; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the schedule of federal financial assistance.
- d. Management has complied with reporting requirements in connection with federal financial assistance.
- e. Information presented in federal financial reports and claims for advances and reimbursements is supported by the books and records from which the basic financial statements have been prepared.
- f. Amounts claimed or used for matching were determined in accordance with OMB Circular A-87, "Cost Principles for State and Local Governments," and the OMB's "Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments."
- g. Management has monitored subrecipients to determine that the subrecipients expend financial assistance in accordance with applicable laws and regulations and have met the requirements of OMB Circular A-128 or OMB Circular A-133, whichever is applicable.
- h. Management has taken appropriate corrective action on a timely basis after receipt of a subrecipient's auditor's report that identifies noncompliance with federal laws and regulations.

- i. Management has considered the results of subrecipients' audits and made any necessary adjustments to the entity's own books and records.
- j. Management has identified and disclosed to the auditor all amounts questioned and known noncompliance with requirements that could have a material effect on a major federal financial assistance program.

92. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to require a qualified opinion or disclaimer of opinion on compliance with the specific requirements.⁴¹ Further, the auditor should consider the effects of management's refusal on his or her ability to rely on other management representations.

Responsibilities Under OMB Circular A-133

93. OMB Circular A-133, "Audits of Institutions of Higher Education and Other Nonprofit Institutions," prescribes audit requirements for institutions of higher education and other nonprofit institutions receiving federal awards (either directly or indirectly). Circular A-133 states that nonprofit institutions receiving \$100,000 or more per year in federal awards are to have an audit performed in accordance with Circular A-133. (The definition of *federal award* is broader than the definition of *federal financial assistance*. See footnote 9.) Nonprofit institutions receiving \$100,000 or more but receiving awards under only one program have the option of having an audit performed in accordance with the provisions of Circular A-133 or having an audit made of the one program. Nonprofit institutions that receive at least \$25,000 but less than \$100,000 per year in federal awards have the option of having an audit performed in accordance with Circular A-133 or of having an audit made of each federal award. Nonprofit institutions receiving less than \$25,000 per year in federal awards are exempt from federal audit requirements, but records are to be available for review by appropriate officials of the federal grantor agency or subgranting entity.

⁴¹ See paragraph 84 of this Statement for an illustration of the auditor's report on compliance with specific requirements when the auditor concludes that management's refusal to provide written representations is cause for a disclaimer of opinion.

94. The auditor is to test and report on matters pertaining to—
- a. Compliance with laws and regulations that may have a direct and material effect on the entity's financial statement amounts.
 - b. Compliance with the general requirements applicable to the federal award programs.
 - c. Compliance with specific requirements that may have a direct and material effect on each major program, as defined in OMB Circular A-133. OMB Circular A-133 defines a major program as one in which federal expenditures total the larger of 3 percent of total federal funds expended or \$100,000. Each of the following categories of federal awards constitutes a major program: research and development; student financial aid; individual awards not in the student aid or research-and-development category. (Under the Single Audit Act and OMB Circular A-128, a major program is defined as one in which federal expenditures total the larger of 3 percent of total federal expenditures or \$300,000.)
 - d. Compliance with certain laws and regulations applicable to nonmajor federal financial assistance programs.

95. These reports are similar to those required by the Single Audit Act and OMB Circular A-128; therefore, the guidance in paragraphs 43 through 92 of this Statement is also generally applicable to audits in accordance with OMB Circular A-133. Among the other audit reports required by OMB Circular A-133 are reports on the financial statements, on the supplementary schedule of federal awards, and on the internal control structure policies and procedures relevant to federal awards. However, OMB Circular A-133, unlike OMB Circular A-128, does not require the auditor to include a description of immaterial noncompliance in the audit reports. However, immaterial noncompliance is required to be reported in a separate written communication to the institution, which management is required to submit to the appropriate federal grantor agencies or subgrantor sources.

Other Compliance Auditing Responsibilities

Program-Specific Audits

96. Under certain circumstances, the Single Audit Act and OMB Circular A-128 and OMB Circular A-133 permit certain recipients of federal financial assistance to have a "program-specific" audit. Entities

not covered by the Single Audit Act or OMB Circular A-133 may also engage an auditor to conduct a program-specific audit in accordance with a federal audit guide (such as the U.S. Department of Education's *Student Financial Aid Audit Guide* or the U.S. Department of Housing and Urban Development's *Consolidated Audit Guide for Audits of HUD Programs*) or in accordance with an agreement from the grantor agency. When engaged to conduct a program-specific audit, the auditor should obtain an understanding of the audit requirements for that particular program from the agreement with the grantor agency, from an audit guide published by the grantor agency, or through contact with the grantor agency.

97. The testing and reporting responsibilities of an engagement to conduct a program-specific audit will vary depending on the requirements of the grantor agency. Those responsibilities may differ from those addressed in this Statement. The guidance provided in this Statement should be applied to these engagements as it is applicable to the specific program.

State and Local Laws and Regulations

98. An auditor may also be engaged to test and report on compliance with state and local laws and regulations other than those discussed in the preceding paragraphs of this Statement.

99. In such cases, auditors should consider performing the following procedures:

- a. Inquire of management about additional compliance auditing requirements applicable to the entity.
- b. Inquire of the office of the state or local auditor or other appropriate audit oversight organization about audit requirements applicable to the entity.
- c. Review information about governmental audit requirements available from state societies of CPAs or associations of governments.

Effective Date

100. The provisions of this Statement are effective for audits of financial statements and of compliance with laws and regulations for

fiscal periods ending after June 15, 1992. Early application of this Statement is encouraged.

Transitional Guidance

101. The auditor should be aware that the OMB issued a revised Compliance Supplement for State and Local Governments in September 1990 that requires that the general requirements “be included as part of every audit of State, local, and Tribal government that involves federal financial assistance whether or not the government has a major program.” Although this Statement, which provides guidance on the revised requirements, is not effective immediately, the revised requirements are already effective. To meet the new requirements, the auditor should consider early application of the guidance in paragraphs 47 and 49 of this Statement. Furthermore, auditors should be aware that existing federal requirements, such as OMB Circular A-133 and the Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions, may have effective dates that precede the effective date of this Statement.

Appendix A

Audit and Reporting Requirements Under the Single Audit Act and OMB Circular A-128, or Under OMB Circular A-133

The following table shows procedures performed and reports issued in an audit in accordance with the Single Audit Act of 1984 and OMB Circular A-128, or in accordance with OMB Circular A-133. The table refers to guidance on procedures or reports that differ from those ordinarily performed or issued in an audit conducted in accordance with generally accepted auditing standards. Additional guidance may be found in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and related AICPA statements of position. The AICPA plans to issue a statement of position that would provide guidance on OMB Circular A-133 requirements.

<i>Procedures Performed</i>	<i>Report Issued</i>
1. Audit of the financial statements in accordance with generally accepted auditing standards	<ul style="list-style-type: none"> • Opinion on the financial statements • Report on supplementary schedule of federal financial assistance
2. Audit of the financial statements in accordance with <i>Government Auditing Standards</i>	<ul style="list-style-type: none"> • Report on compliance with laws and regulations that may have a material effect on the financial statements • Report on internal control structure-related matters based solely on an assessment of control risk performed as part of the audit of the financial statements
3. Obtain an understanding of the internal control structure over federal financial assistance, assess control risk, and perform tests of controls	<ul style="list-style-type: none"> • Report on internal controls over federal financial assistance
4. Testing of compliance with general requirements applicable to federal financial assistance programs and audit of compliance with specific requirements applicable to major federal financial assistance programs as defined by the Single Audit Act or OMB Circular A-133	<ul style="list-style-type: none"> • Report on compliance with general requirements applicable to federal financial assistance programs • Opinion on compliance with specific requirements applicable to <i>each</i> major federal financial assistance program • Schedule of findings and questioned costs

Procedures Performed

5. Testing of compliance with laws and regulations applicable to nonmajor federal financial assistance program transactions selected for testing in connection with procedure 1 or 3

Report Issued

- Report on compliance with laws and regulations applicable to nonmajor federal financial assistance program transactions tested
- Schedule of findings and questioned costs

Appendix B

Examples of Effects of Certain Laws and Regulations on a Governmental Entity's Financial Statements

1. Following are some of the types of laws and regulations that may have a direct and material effect on the determination of amounts in a governmental entity's financial statements. These types of laws and regulations may be relevant to an entity whether or not it is legally required to prepare financial statements in accordance with generally accepted accounting principles.

a. *Reporting entity*—For those entities required by law or regulation to prepare financial statements in accordance with generally accepted accounting principles, section 2100 of the *GASB Codification* establishes criteria for determining the organizations, functions, and activities of government that should be included in the general purpose financial statements of a governmental entity. These criteria include manifestation of oversight responsibility, accountability for fiscal matters, scope of public services, and special financing relationships. In applying these criteria to define the reporting entity, management should consider applicable laws and regulations.

b. *Establishment of funds*—Section 1300 of the *GASB Codification* establishes the principles of fund accounting. It notes that—

Various types of legal provisions require establishment of funds. At the state level, funds may be created pursuant to constitutional provisions or statutes enacted by the legislative body. A local government's funds may be established by state constitutional provisions or statutes, or by local charters, ordinances, and governing body orders.

For example, a state constitution may require that proceeds of a state gasoline tax be accounted for in a special revenue fund.

c. *Budgetary reporting*—An appropriated budget is the expenditure authority created by appropriation bills or ordinances that are signed into law and the related estimated revenues. Section 2400 of the *GASB Codification* requires that the general purpose financial statements present an aggregation of the appropriated budgets, as amended, compared to actual results of operations.

d. *Matching requirements*—A grantor may require grantees to contribute their own resources toward carrying out the activity funded with a grant. A grant is a contribution of cash or other assets from another government to be used or expended for a specified purpose, activity, or facility. Section G60.109 of the *GASB Codification* states that if such matching requirements exist, revenue recognition depends on compliance with those requirements.

- e. *Restrictions on expenditures*—The purposes for which the proceeds of certain governmental revenues may be expended are restricted by law. For example, a state constitution may require that proceeds of a state gasoline tax be expended only for maintenance of highways. Similarly, legislation enacting a housing grant program may require governmental entities receiving the grant to distribute the proceeds only to families meeting certain eligibility tests. Restrictions on expenditures do not necessarily require establishment of a special revenue fund. Section 1300.107 of the *GASB Codification* notes that “resources restricted to expenditure for purposes normally financed from the general fund may be accounted for through the general fund provided that applicable legal requirements can be appropriately satisfied, and use of special revenue funds is not required unless they are legally mandated.”
- f. *Taxing and debt limitations*—Certain governmental entities may be subject to laws and regulations that place limits on local government taxing authority, place ceiling limitations and other issuance criteria on debt, or place limits on the use of debt proceeds.
- g. *General requirements*—Certain of the general requirements identified in the OMB’s *Compliance Supplements* may have a direct and material effect on the determination of financial statement amounts in certain circumstances. For example, indirect costs may not have been properly allocated to federal programs. Such an action would be a violation of OMB Circular No. A-87, “Cost Principles for State and Local Governments,” referred to in the allowable costs/cost principles general requirement, and would have a direct effect on the determination of cost-related amounts in the entity’s financial statements.

2. The *GASB Codification* also includes requirements to disclose violations of certain laws and regulations. Section 2300.104 of the *GASB Codification* states: “Notes to the financial statements essential to fair presentation at the GPFS [general purpose financial statements] level include . . . [m]aterial violations of finance-related legal and contractual provisions.” The auditor’s consideration of the adequacy of such disclosure includes an evaluation of the governmental entity’s compliance with laws and regulations that could have a direct and material effect on the determination of financial statement amounts. The following are examples of violations of those laws and regulations that a governmental entity may be required to disclose:

- a. Failure to establish funds required by law
- b. Expenditures in excess of a legally appropriated budget
- c. Expenditure of the proceeds of a grant without satisfying matching requirements
- d. Expenditure of the proceeds of a tax in violation of legal restrictions on use of those proceeds
- e. Issuance of debt in excess of ceiling limitations imposed by law

3. In section 150.161 and .162, the GASB *Codification* specifically requires governmental entities to disclose the types of investments they are legally authorized to make and any violations of legal or contractual provisions for deposits and investments. When these disclosures have been made by management, the auditor should also evaluate a governmental entity's compliance with legal provisions for deposits and investments. The auditor's responsibility to evaluate compliance with these legal provisions arises since the disclosures are specifically required by generally accepted accounting principles, not because the legal provisions have a direct and material effect on the determination of financial statement amounts.

Glossary

Award. Defined by OMB Circular A-133 as financial assistance and federal cost-type contracts used to buy services or goods for the use of the federal government. It does not include procurement contracts to vendors under grants or contracts used to buy goods or services.

Catalog of Federal Domestic Assistance. A government-wide summary of federal programs, services, and activities administered by the departments and establishments of the federal government that provide assistance and benefits to the U.S. public.

Common Rule. Issued by federal agencies to implement OMB Circular A-102, “Uniform Requirements for Grants to State and Local Governments.” Establishes uniform administrative rules for federal grants and cooperative agreements and subawards to state, local, and Indian Tribal governments. The rules, which apply to grants awarded on or after October 1, 1988, are organized according to the major steps in the grants process: pre-award, post-award, and after-the-grant.

Compliance Supplements. Published by the OMB to specify the general and specific program compliance requirements and suggested audit procedures for federal programs. There are two compliance supplements: the supplement to OMB Circular A-128, *Compliance Supplement for Single Audits of State and Local Governments* (revised September 1990), and the supplement to OMB Circular A-133, *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions*.

Disallowed cost. Defined by the Inspector General Act Amendments of 1988 as a questioned cost that management, in a management decision, has sustained or agreed should not be charged to the government.

Earmarking. Laws and regulations specific to a program that specify the nature of projects that organizations may fund with financial assistance received from the government.

GAO. The United States General Accounting Office, the main purposes of which are (1) to assist Congress in carrying out legislative and oversight responsibilities; (2) to carry out legal, accounting, auditing, and claims settlement functions with respect to federal government programs; and (3) to make recommendations for providing more efficient and effective government operations.

General requirements. Specified in the *Compliance Supplements* as “those requirements that involve significant national policy and of which failure to comply could have a material impact on an organization’s financial statements.”

Accordingly, tests for compliance with those requirements “should be included as a part of every audit of state, local, and Tribal governments that involves federal financial assistance.” Those requirements pertain to the following matters:

- a. *Political activity* prohibits the use of federal funds for partisan political activity.
- b. *Davis-Bacon Act* requires that laborers working on federally financed construction contracts be paid a wage established by the Secretary of Labor.
- c. *Civil rights* prohibits violation of anyone’s civil rights in a program funded by the federal government.
- d. *Cash management* requires recipients of federal assistance to minimize the time lapsed between receipt and disbursement of that assistance.
- e. *Relocation assistance and real property acquisition* prescribes how real property should be acquired with federal financial assistance and how recipients must help relocate people displaced when that property is acquired.
- f. *Federal financial reports* prescribes federal financial reports that must be filed.
- g. *Allowable costs/cost principles* require that costs charged to programs comply with federal cost principles.
- h. *Drug-Free Workplace Act* requires recipients to certify that they will provide a drug-free workplace.
- i. *Administrative requirements* require compliance with the applicable administrative requirements in the common agency regulations.

Government Auditing Standards. Issued by the Comptroller General of the United States as the *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions* (1988 revision), this document contains audit standards that must be followed for audits of federal organizations, programs, activities, functions, and funds received by contractors, nonprofit organizations, and other external organizations. The document is also recommended for audits of state and local government organizations, programs, activities, and functions.

Level of effort. Laws and regulations specific to a program that require an organization that receives financial assistance from the government to maintain a specified level of participation through the contribution of the organization’s resources.

Major federal award program. Defined by OMB Circular A-133 as an individual award or group of awards in a category of federal assistance or support for which total expenditures are the larger of 3 percent of total federal funds expended or \$100,000. Each of the following categories of federal awards

shall constitute a major program, in which total expenditures are the larger of 3 percent of total federal funds expended or \$100,000:

- a. Research and development
- b. Student financial aid
- c. Individual awards not in the student aid or research-and-development category

Major federal financial assistance program. Defined by the Single Audit Act as any federal financial assistance program for which total expenditures of that assistance during the applicable program year exceed—

- a. \$20 million, when expenditures for all programs exceed \$7 billion.
- b. \$19 million, when expenditures for all programs exceed \$6 billion but are less than or equal to \$7 billion.
- c. \$16 million, when expenditures for all programs exceed \$5 billion but are less than or equal to \$6 billion.
- d. \$13 million, when expenditures for all programs exceed \$4 billion but are less than or equal to \$5 billion.
- e. \$10 million, when expenditures for all programs exceed \$3 billion but are less than or equal to \$4 billion.
- f. \$7 million, when expenditures for all programs exceed \$2 billion but are less than or equal to \$3 billion.
- g. \$4 million, when expenditures for all programs exceed \$1 billion but are less than or equal to \$2 billion.
- h. \$3 million, when expenditures for all programs exceed \$100 million but are less than or equal to \$1 billion.
- i. The larger of \$300,000 or 3 percent of total expenditures for all programs, when expenditures for all programs exceed \$100,000 but are less than or equal to \$100 million.

Noncompliance. The failure to act in accordance with the laws, regulations, and contractual terms governing financial assistance that an entity received from a governmental agency.

Nonmajor federal financial assistance program. All federal financial assistance programs that do not meet the specified criteria of a major program.

OMB. The United States Office of Management and Budget.

OMB Circular A-21. “Cost Principles for Educational Institutions,” issued by the OMB to provide that federal assistance programs provided to educational institutions bear their fair share of costs by defining costs that are allowable and unallowable for that assistance.

OMB Circular A-87. “Cost Principles for State and Local Governments,” issued by the OMB to provide that federal assistance programs provided to state

and local governments and Indian Tribal governments bear their fair share of costs by defining costs that are allowable and unallowable for that assistance.

OMB Circular A-102. “Uniform Requirements for Grants to State and Local Governments,” issued by the OMB to provide a uniform approach for administration of federal assistance programs.

OMB Circular A-110. “Uniform Requirements for Grants to Universities, Hospitals, and Other Nonprofit Organizations,” issued by the OMB to establish standards (such as insurance requirements, record retention requirements, and banking requirements) for obtaining consistency and uniformity among federal agencies in the administration of grants to and agreements with public and private institutions of higher education, public and private hospitals, and other quasi-public and private nonprofit organizations. Does not apply to grants, contracts, and other agreements between the federal government and units of state and local governments.

OMB Circular A-122. “Cost Principles for Nonprofit Organizations,” issued by the OMB to provide that federal assistance programs provided to nonprofit organizations bear their fair share of costs by defining costs that are allowable and unallowable for that assistance. This circular does not apply to—

- a. Colleges and universities.
- b. State, local, and Indian Tribal governments.
- c. Hospitals.

OMB Circular A-128. “Audits of State and Local Governments,” issued by the OMB to facilitate the implementation of the Single Audit Act of 1984, establishes specific audit requirements for state and local governments that receive federal financial assistance and defines federal responsibilities for implementing and monitoring those requirements.

OMB Circular A-133. “Audits of Institutions of Higher Education and Other Nonprofit Institutions,” issued by the OMB to establish audit requirements for institutions of higher education and other nonprofit institutions receiving federal awards and to define federal responsibilities for implementing and monitoring those requirements.

Primary recipient. The entity receiving governmental financial assistance directly from the governmental program creating and providing the financial assistance.

Questioned cost. Defined in the Inspector General Act Amendments of 1988 as (1) an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds; (2) a finding that, at the time of the audit, such cost is not supported by adequate documentation; or (3) a finding that the expenditure of funds for the intended purpose is unnecessary or unreasonable.

Single Audit Act of 1984. The United States federal statute (Public Law 98-502) that establishes uniform requirements for audits of federal financial assistance provided to state and local governments. These requirements focus on a single coordinated audit of the aggregate federal financial assistance provided to a government, with special emphasis on defined major federal financial assistance programs. The requirements include—

- a. An audit of the general purpose financial statements.
- b. Additional tests for compliance with applicable laws and regulations related to federal assistance programs received.
- c. Reviews of internal control systems for federal financial assistance received.

Specific requirements. Defined in the *Compliance Supplements* as those requirements that pertain to the following categories:

- a. Types of services allowed or unallowed
- b. Eligibility
- c. Matching, level of effort, or earmarking
- d. Reporting
- e. Special tests and provisions

In addition to these five requirements, the auditor should consider the requirements listed in paragraph 59 of this Statement when reporting on compliance with specific requirements.

Subrecipient. An entity receiving governmental financial assistance when that assistance is initially received by another entity that distributes the assistance for the government program that created and provided the assistance.

This Statement entitled Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance was adopted unanimously by the seventeen members of the board.

Auditing Standards Board (1991)

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