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

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AICPA AUDIT AND ACCOUNTING GUIDE

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

***AUDITS OF
STATE AND LOCAL
GOVERNMENTAL
UNITS***

***With Conforming Changes as of
May 1, 1999***

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AUDITS OF STATE AND LOCAL GOVERNMENTAL UNITS

***With Conforming Changes as of
May 1, 1999***

This edition of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, which was originally issued in 1994, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued (see page iv). The changes made are identified in a schedule in appendix O of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

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NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Government Accounting and Auditing Committee on the application of generally accepted auditing standards to audits of financial statements of state and local governmental units. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for state and local governmental units. The AICPA Accounting Standards Executive Committee and members of the AICPA Auditing Standards Board have found this guide to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from this guide.

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Connie L. Robins
James M. Williams, Jr.
Jeffrey B. Winter

AICPA Staff

Susan Frohlich
Technical Manager
Accounting and Auditing Publications

This Guide reflects relevant guidance contained in authoritative pronouncements through May 1, 1999:

*GASB Statement No. 33, Accounting and Financial Reporting for Nonexchange Transactions**

GASB Interpretation No. 5, Property Tax Revenue Recognition in Governmental Funds

*GASB Technical Bulletin 99-1, Disclosures about Year 2000 Issues—an Amendment of Technical Bulletin 98-1***

SAS No. 87, Restricting the Use of an Auditor's Report

Users of this Guide should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this Guide.

* Because GASB Statement No. 33 is effective for financial statements for periods beginning after June 15, 2000, with earlier application encouraged, guidance that is still applicable could not be deleted from the guide and replaced by the guidance from GASB Statement No. 33. Instead, a summary adapted from GASB Statement No. 33 has been included at paragraphs 8.17 through 8.24, and footnote references to GASB Statement No. 33 have been included in other sections of this guide.

** The provisions of GASB Technical Bulletin 99-1, *Disclosures about Year 2000 Issues—an Amendment of Technical Bulletin 98-1*, terminate for financial statements for periods ending after December 31, 1999, unless mission-critical systems and other equipment are not operating because of the year 2000 issue as of the balance sheet date. Accordingly, references to GASB Technical Bulletins 99-1 and 98-1, *Disclosures about Year 2000 Issues*, have been included in footnote format in chapters 17 and 18.

Preface

This guide supersedes the 1986 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and subsequent editions of that guide with conforming changes made by the AICPA staff. It has been prepared to assist the independent auditor in auditing the financial statements of governmental units other than the federal government. AICPA Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, included as appendix M, provides guidance to independent auditors planning or conducting audits involving federal awards under the requirements of the Single Audit Act Amendments of 1996. The guide is intended to be an initial reference source for the independent auditor who is new to governmental accounting and auditing. It assumes that the reader has expertise in accounting and auditing generally, but not in the specialized accounting or auditing practices applicable to state or local governmental units. Accordingly, the discussion of audit procedures concentrates primarily on those unique to governmental audits. The nature, timing, and extent of such auditing procedures are a matter of professional judgment and will vary depending upon the size, organizational structure, existing internal control, and other factors in a particular engagement. The guide includes audit guidance through the AICPA's Statement on Auditing Standards (SAS) No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532).

The intent of the guide is to discuss accounting pronouncements and recognized practices unique to governmental units. It contains accounting guidance, some of which was in the 1986 Audit and Accounting Guide *Audits of State and Local Governmental Units* but not addressed in Governmental Accounting Standards Board (GASB) pronouncements, and some of which is new guidance. The guidance provided on issues not addressed in GASB pronouncements, however, is *neutral*—that is, the alternative accounting and reporting possibilities are presented, but without recommendations for one alternative over another. Readers should review the annually updated Audit Risk Alert, *State and Local Governmental Developments*, a publication in the AICPA series that identifies and discusses audit and accounting developments. Paragraphs 12 and 13 of SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411.12 and .13), address the application to state and local governmental entities of established accounting principles that are generally accepted in the United States. The GASB's *Codification of Governmental Accounting and Financial Reporting Standards* and any GASB Statements issued after its publication date contain the governmental accounting and reporting standards. This guide includes accounting and reporting guidance through GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, GASB Interpretation No. 5, *Property Tax Revenue Recognition in Governmental Funds*, and GASB Technical Bulletin 99-1, *Disclosures about Year 2000 Issues—an Amendment of Technical Bulletin 98-1*. The effective dates of this guidance should be applied as provided for in the related literature.

Because GASB Statement No. 33 is effective for financial statements for periods beginning after June 15, 2000, with earlier application encouraged, guidance that is still applicable could not be deleted from the guide and replaced by the guidance from GASB Statement No. 33. Instead, a summary adapted from GASB Statement No. 33 has been included at paragraphs 8.17 through 8.24, and footnote references to GASB Statement No. 33 have been included in other sections of this guide.

The provisions of GASB Technical Bulletin 99-1, *Disclosures about Year 2000 Issues—an Amendment of Technical Bulletin 98-1*, terminate for financial statements for periods ending after December 31, 1999, unless mission-critical systems and other equipment are not operating because of the year 2000 issue as of the balance sheet date. Accordingly, references to GASB Technical Bulletins 99-1 and 98-1, *Disclosures about Year 2000 Issues*, have been included in footnote format in chapters 17 and 18.

This guide includes the provisions of the 1994 revision to *Government Auditing Standards* issued by the U.S. General Accounting Office (GAO).

The auditing guidance in the guide is effective for audits of financial statements for fiscal periods ending after September 15, 1994. This printing of the guide includes conforming changes as of May 1, 1999. These conforming changes are effective as of the effective date of the pronouncements to which they relate.

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-

Part I

Introduction

Chapter 1

Overview

Introduction

1.01 Governmental accounting and auditing is unique in many respects. Its multifund structure, extensive reporting requirements, basis of accounting, and budgetary and other legal compliance requirements present an environment that is significantly different from that encountered in the audit of a commercial or not-for-profit organization. An audit of a governmental unit may be conducted under three different *levels* of audit standards or requirements: generally accepted auditing standards (GAAS), the standards applicable to financial statement audits contained in the 1994 revision to *Government Auditing Standards* (often called the Yellow Book, generally accepted government auditing standards, or GAGAS) issued by the Comptroller General of the United States, or the additional requirements of the Single Audit Act Amendments of 1996 (the Single Audit Act). The different requirements for a financial statement audit encompassed by GAAS and *Government Auditing Standards* are discussed in this guide. AICPA Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, which is included in appendix M to this guide, provides detailed guidance on audits of federal awards and the requirements of the Single Audit Act. The auditor, before accepting an engagement, should understand which auditing standards or requirements apply to the engagement.

1.02 AICPA Statement on Auditing Standards (SAS) No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), states that, 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 GAAS may not satisfy the relevant legal, regulatory, or contractual requirements. See chapter 5, "Testing and Reporting on Compliance With Laws and Regulations," paragraphs 5.03 through 5.07, for a discussion of the requirements of SAS No. 74 relating to the auditor's responsibilities in this situation.

1.03 There are over 86,000¹ state and local governmental units in the United States. These include the following:

- States
- Counties
- Cities, towns, and villages
- School districts
- Municipal utility districts
- Public benefit corporations and authorities

¹ U.S. Bureau of the Census, *Census of Governments, 1992*, vol. 1, no. 1, Government Organization.

- Public employee retirement systems (PERS)
- Governmental colleges and universities
- Governmental hospitals and other providers of health care services
- Other special purpose districts and authorities, established to provide services such as sanitation, or to manage enterprises such as toll roads and airports

The Role of This Guide

1.04 The purpose of this guide is to provide guidance for accounting, auditing, and reporting on the financial statements of state and local governmental entities. The guide is based on existing pronouncements of authoritative standard-setting boards as well as other sources of generally accepted accounting principles (GAAP). It does not establish new accounting principles or auditing standards, or modify existing ones. Hence, its guidance may have been superseded by standards or regulations issued since its publication. Therefore, when planning and conducting an audit engagement, the auditor should refer to the most recent pronouncements of the Governmental Accounting Standards Board (GASB), the Auditing Standards Board and the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AICPA), the Comptroller General of the United States, the U.S. General Accounting Office (GAO), the U.S. Office of Management and Budget (OMB), and pertinent government agencies.

1.05 This guide should be followed when the auditor is engaged to audit a governmental college or university that has elected to account for its activities using the “governmental model.” An auditor engaged to audit a governmental college or university that has elected to account for its activities using the “AICPA college guide model” should also refer to the guidance in the AICPA Industry Audit Guide *Audits of Colleges and Universities*. (Auditors should note that although *Audits of Colleges and Universities* has been superseded by the recently issued Audit and Accounting Guide *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment.) These alternative models are recognized in the *Codification of Governmental Accounting and Financial Reporting Standards* (GASB Codification), Section Co5 (GASB Cod. sec. Co5), which states that governmental colleges and universities should use one of the following two accounting and financial reporting models:

- a. The AICPA college guide model.** The accounting and financial reporting guidance recognized by the AICPA Industry Audit Guide *Audits of Colleges and Universities* as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable Financial Accounting Standards Board (FASB) pronouncements issued through November 30, 1989, and by all applicable GASB pronouncements.
- b. The governmental model.** The accounting and financial reporting standards established by the National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, as modified by subsequent NCGA and GASB pronouncements.

1.06 If the auditor is engaged to audit the separate financial statements of a governmental health care entity (that is, a governmental hospital or other

provider of health care services) that uses enterprise fund accounting and reporting, the auditor should refer to the AICPA Audit and Accounting Guide *Health Care Organizations*, GASB literature, and, if applicable, SOP 98-3. Chapters 3, “Planning the Audit,” and 15, “Special Governmental Units,” provide further guidance.

1.07 If the auditor is engaged to audit a PERS, the auditor should refer to GASB Cod. secs. Pe5 and Pe6 for accounting and financial reporting guidance. The auditor should refer to chapter 14 of this guide for audit guidance.

1.08 If the auditor is engaged to audit the separate financial statements of a governmental entity that heretofore has applied not-for-profit accounting and financial reporting principles, the auditor should refer to GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*. GASB Statement No. 29 provides that these entities should account for their activities using either the “governmental model” or the “AICPA not-for-profit model.” The following describes each alternative model:

- a. **The AICPA not-for-profit model.** The accounting and financial reporting principles contained in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*—except for the provisions relating to the joint costs of informational materials and activities that include a fund-raising appeal—as modified by all applicable FASB pronouncements issued through November 30, 1989, and as modified by most applicable GASB pronouncements. (Auditors should note that although SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations* have been superseded by the recently issued Audit and Accounting Guide *Not-for-Profit Organizations*, they continue to be applicable in a governmental environment. See also SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, in appendix L.)
- b. **The governmental model.** The accounting and financial reporting standards established by the NCGA Statement 1, as modified by subsequent NCGA and GASB pronouncements. An auditor engaged to audit a governmental entity that has elected to account for its activities using the governmental model should refer to this guide for audit guidance.

1.09 The guidance presented here is not all-inclusive; rather, it is limited to matters that warrant special emphasis or that experience has indicated may be useful. This guide is based on the assumption that its users are, for the most part, knowledgeable in accounting and auditing, so it focuses on specific areas of auditing, accounting, and reporting with respect to the financial statements of state and local governments. Accordingly, the guide does not discuss the application of all GAAP and GAAS as they pertain to the audit of such financial statements. The nature, timing, and extent of auditing procedures are matters of professional judgment and will vary according to the size of the entity, the operations and administrative structure, the auditor’s assessment of the level of risk, and other factors. The independent auditor is also expected to be familiar with applicable governmental laws and regulations.

Background

1.10 Accounting Principles. In 1968, NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles* was published. At its

time of publication, this source was recognized widely as an authoritative reference for GAAP for state and local governmental units. However, it is no longer authoritative.

1.11 In 1979, the NCGA issued the first of its seven statements and eleven interpretations providing additional guidance on governmental accounting and reporting matters, and, subsequently, issued additional statements and interpretations expanding on the basic principles established in its first statement. Although the NCGA was not recognized by the AICPA as a standard-setting body (and, therefore, not officially recognized as a source of GAAP for government), NCGA statements and interpretations were widely followed and generally accepted by preparers of and attestors to the financial statements of state and local governments.

1.12 In 1984, the Financial Accounting Foundation (FAF) created the Governmental Accounting Standards Board. The GASB is recognized as the standard-setting authority of GAAP for state and local units of government, as discussed in paragraphs 1.17 through 1.19. (GASB Statement No. 1, *Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide*, paragraph 8, addresses the authoritative status of NCGA Statements and Interpretations.) The FASB and the GASB have agreed on the definition of a *governmental organization*. This agreement was reached in a public meeting in which the FASB and the GASB cleared the proposed Audit and Accounting Guide *Health Care Organizations* for final issuance. Therefore, the following definition of a governmental organization should be considered by auditors in determining whether an entity is applying the appropriate GAAP:

Public corporations and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:

- Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments;
- The potential for unilateral dissolution by a government with the net assets reverting to a government; or
- The power to enact *and* enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

1.13 ***Auditing Standards.*** In addition to GAAS established by the AICPA, auditors of state and local governmental units may also need to comply with *Government Auditing Standards*. Certain aspects of GAAS and *Government Auditing Standards* establish auditing and reporting requirements for state and local governmental units that extend beyond those required in a financial audit of most for-profit organizations.

1.14 When auditing a governmental unit, the auditor may be required to comply with the audit requirements of the Single Audit Act Amendments of 1996. The Single Audit Act Amendments, which establishes audit requirements for state and local governments expending federal awards, imposes auditing

and reporting requirements beyond those required by GAAS and *Government Auditing Standards*. Audits conducted under the requirements of the Single Audit Act are referred to as *single audits*. Auditors should refer to SOP 98-3 in appendix M for guidance on performing single audits.

1.15 Auditing in the state and local governmental arena includes several other unique aspects. Governmental organizations, by their nature, manage public funds, rather than those of an individual, a closely held group, or a voluntary investment in a venture. Therefore, there is, perhaps, more public interest in the accountability for those funds. There may be qualitative issues, such as controversial new revenue sources or projects, or job performance issues, that an auditor may need to address but that may not be part of an audit of the financial statements of non-governmental organizations. Additionally, public funds are required to be administered in accordance with laws and regulations for which noncompliance could have a material effect on the government's financial statements. Because of these unique aspects, *Government Auditing Standards* notes that auditors may set lower materiality levels in an audit of the financial statements of a government entity or an entity that receives government assistance than in audits in the private sector.

Organization of This Guide

1.16 This guide is organized as follows:

- Part I, "Introduction," discusses the financial reporting entity and fund structure. This discussion takes into consideration the fact that governmental units become involved in a variety of ventures, which may or may not be part of the audited entity. It also provides guidance on planning the audit, the auditor's understanding of the entity's internal control, and compliance testing.
- Part II, "The State and Local Government Audit—Governmental Funds and Account Groups," addresses the budget, cash and investments, receivables and revenues, expenditures and related liabilities, capital expenditures and related fund and account group activity, debt and debt service, and interfund transactions and fund equity.
- Part III, "The State and Local Government Audit—Proprietary and Fiduciary Funds," addresses enterprise funds, internal service funds, expendable trust funds, nonexpendable trust funds, pension trust funds and agency funds.
- Part IV, "Other Governmental Audit Engagements," highlights special governmental units and state governments.
- Part V, "Concluding the Audit," discusses representations from management, related party transactions, going concern considerations, commitments and contingencies, subsequent events, and analytical procedures.
- Part VI, "Auditor's Reports," discusses auditor's reports on basic or general-purpose financial statements (GPFS) and association with financial statements included in official statements.

Generally Accepted Accounting Principles for State and Local Governments

1.17 The sources of established accounting principles that are generally accepted in the United States are—

- a. Accounting principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to Rule 203 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 203.01). Rule 203 provides that an auditor should not express an unqualified opinion if the financial statements contain a material departure from such pronouncements unless, due to unusual circumstances, adherence to the pronouncements would make the statements misleading. Rule 203 states that the application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows, in conformity with GAAP. Nevertheless, Rule 203 provides for the possibility that the literal application of such a pronouncement might, in unusual circumstances, result in misleading financial statements. (See paragraphs 14 and 15 of SAS No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1, AU sec. 508.14 and .15].)
- b. Pronouncements of bodies, composed of expert accountants, that deliberate accounting issues in public forums for the purpose of establishing accounting principles or describing existing accounting practices that are generally accepted, provided those pronouncements have been exposed for public comment and have been cleared by a body referred to in category *a* (see paragraph 1.18). The word *cleared* means that a body referred to in subparagraph *a* has indicated that it does not object to the issuance of the proposed pronouncement.
- c. Pronouncements of bodies, organized by a body referred to in category *a* and composed of expert accountants, that deliberate accounting issues in public forums for the purpose of interpreting or establishing accounting principles or describing existing accounting practices that are generally accepted, or pronouncements referred to in category *b* (see paragraph 1.18) that have been cleared by a body referred to in category *a* but have not been exposed for public comment.
- d. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry, or the knowledgeable application to specific circumstances of pronouncements that are generally accepted.

1.18 The GASB is the recognized standard-setting authority of GAAP for state and local governments. However, in the absence of a relevant pronouncement by the GASB, auditors may look to other sources for authoritative guidance. In 1991, the AICPA issued SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), which adopted a hierarchy of GAAP applicable to state and local governmental entities, indicating the level of authority of various sources. The application of GAAP for financial statements of state and local governmental entities is as follows:

- a. Category *a*, officially established accounting principles, consists of GASB Statements and Interpretations, as well as AICPA and FASB pronouncements specifically made applicable to state and local governmental entities by GASB Statements or Interpretations. GASB Statements and Interpretations are periodically incorporated in the GASB Codification.

- b. Category *b* consists of GASB Technical Bulletins and, if specifically made applicable to state and local governmental entities by the AICPA and cleared² by the GASB, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position.
- c. Category *c* consists of the AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins, if specifically made applicable to state and local governmental entities and cleared by the GASB, as well as consensus positions of a group of accountants organized by the GASB that attempt to reach consensus positions on accounting issues applicable to state and local governmental entities.³
- d. Category *d* includes implementation guides (*Qs and As*) published by the GASB staff, as well as practices that are widely recognized and prevalent in state and local government.

1.19 In the absence of a pronouncement covered by Rule 203 or another source of established accounting principles, the auditor of financial statements of state and local governmental entities may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, GASB Concepts Statements; the pronouncements referred to in categories *a* through *d* of SAS No. 69, paragraph 10 (AICPA, *Professional Standards*, vol. 1, AU sec. 411.10) (consisting principally of FASB Statements and Interpretations), when not specifically made applicable to state and local governmental entities either by the GASB or by the organization issuing them; Accounting Principles Board (APB) Statements; FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles. The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, GASB Concepts Statements would normally be more influential than other sources in this category. GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, provides guidance on applying the SAS No. 69 hierarchy to governmental units that report using proprietary fund (enterprise and internal service fund) accounting and financial reporting.

Applicable Auditing Standards

1.20 Audits of financial statements of state and local governments should satisfy applicable auditing standards established by the AICPA, which are usually referred to as GAAS. These auditing standards have been issued as Statements on Auditing Standards, Statements of Position, and Auditing Interpretations. SAS No. 74 is particularly relevant to auditors of state and local governments.⁽⁴⁾ (Auditors may also be engaged to provide attest services,

² The auditor should assume that such pronouncements specifically made applicable to state and local governments have been cleared by the GASB, unless the pronouncement indicates otherwise.

³ As of the date of this guide, the GASB had not established such a group.

⁽⁴⁾ [Deleted.]

for example, an engagement to express a conclusion about the reliability of a written assertion that is the responsibility of another party. Those engagements are conducted in accordance with the Attestation Standards, which are not within the scope of this guide.)

1.21 The Comptroller General of the United States has issued *Government Auditing Standards*, which is periodically revised. These standards are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. *Government Auditing Standards* includes requirements relating to the auditor's professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.

1.22 *Government Auditing Standards* incorporates all AICPA audit standards for field work and reporting and its general standards are similar to those of the AICPA. However, *Government Auditing Standards* also contains additional general, field work, and reporting standards. Included in the general standards are additional requirements for continuing professional education and external quality control reviews. For example, auditors responsible for planning or directing an audit, conducting substantial portions of field work, or reporting on an audit under *Government Auditing Standards* are required to complete, every two years, at least eighty hours of continuing education, with at least twenty-four of those hours in subjects directly related to the government environment and government auditing. In addition, organizations conducting government audits are required to have an appropriate internal quality control system in place and undergo an external quality control review. This external quality control review should be conducted at least once every three years. The auditor, when seeking to enter into a contract to perform an audit, should provide his or her most recent external quality control report⁵ to the party contracting for the audit. Further, *Government Auditing Standards*, chapter 3, paragraphs 3.11 through 3.25, contains additional independence requirements for both individual auditors and audit firms or organizations. Auditors should also be aware that certain federal agencies have independence requirements that exceed those in *Government Auditing Standards*.

1.23 *Government Auditing Standards* addresses two types of audits: financial and performance. Financial audits include financial statement and financial related audits. Financial statement audits are defined as providing reasonable assurance about whether the financial statements of an audited entity present fairly the financial position, results of operations, and cash flows in conformity with GAAP. Financial statement audits also include audits of financial statements prepared in conformity with other comprehensive bases of accounting discussed in paragraphs 2 through 10 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.02 through .10). Financial related audits include providing reasonable assurance that financial information is presented in accordance with established or stated criteria, whether the entity has adhered to specific financial compliance requirements, or whether the entity's internal control over financial reporting and/or safeguarding assets is suitably designed and implemented to achieve the control objectives (*Government Auditing Standards*, chapter 2, paragraph 2.4). A performance audit, by contrast, is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to

⁵ The term "report" does not include separate letters of comment.

provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action (*Government Auditing Standards*, chapter 2, paragraph 2.6). Performance audits include economy and efficiency and program audits. This guide provides guidance on financial audits and does not address performance audits.

1.24 The auditor should be aware that AICPA Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits* (AICPA, *Professional Standards*, vol. 2, ET sec. 501.04), states:

If a member...undertakes an obligation to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, in addition to generally accepted auditing standards, he or she is obligated to follow such requirements. Failure to do so is an act discreditable to the profession in violation of Rule 501 of the AICPA Code of Professional Conduct, unless the auditor discloses in his or her report the fact that such requirements were not followed and the reason therefor.

Additional Audit Requirements

1.25 As previously noted, the Single Audit Act imposes additional audit responsibilities on independent auditors of state and local governments expending federal awards. OMB is the federal agency designated as having primary responsibility for implementing the Single Audit Act. OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, sets forth audit requirements for state and local governments expending federal awards. A supporting OMB document, *OMB Circular A-133, Compliance Supplement*, identifies the significant compliance requirements to be considered in single audits of these governments. Single audits are discussed in SOP 98-3 in appendix M.

1.26 Prior to undertaking audits of state and local governments, or of specific government grants, programs, or contracts, independent auditors should be knowledgeable of the compliance requirements and auditing standards that have an impact on the scope of the engagement, including those promulgated by the state or federal agency that has oversight authority over the government or is responsible for administering the specific grant, program, or contract.

Other Sources of Guidance

1.27 The following are nonauthoritative sources of guidance that may be useful in conducting audits of state and local governmental units.

- The AICPA issues an annual Audit Risk Alert *State and Local Governmental Developments*, which provides an overview of economic and industry conditions and recently issued accounting and auditing pronouncements that may affect audits of governmental units.
- The AICPA has also developed a basic audit program for audits of state and local governments. Although the program must be customized for specific engagements, it is a useful starting point for planning a government audit. It is included in a nonauthoritative practice aid, the *Local Governmental Audit and Accounting Manual*.

- The Government Finance Officers Association (GFOA) publishes *Governmental Accounting, Auditing and Financial Reporting (GAAFR)*. Revised periodically, GAAFR features comprehensive explanations of the principles and standards established by the GASB or the AICPA, examples of how to account for specific types of transactions (including journal entries), and illustrations of financial statements.

Chapter 2

The Financial Reporting Entity and Fund Structure

Introduction

2.01 GASB Statement No. 14, *The Financial Reporting Entity* (GASB Cod. sec. 2100 and 2600), revised the standards for defining the financial reporting entity and identifying entities to be included in its GPFS. Even though standards existed before the issuance of GASB Statement No. 14, requirements were inconsistently interpreted, resulting in situations where significant activities controlled by the primary government may have been omitted from the GPFS. Thus, even though GASB Statement No. 14 provides substantial guidance concerning entities to be included in the financial reporting entity's financial statements, the financial reporting entity concept is still a relatively new and evolving area. GASB Statement No. 14 has initiated a concept of *discrete* presentation by the separation of some component units⁶ from the primary government.

2.02 GASB Cod. sec. 2100 provides guidance to determine which component units should be included in the primary government's financial statements. Requirements for inclusion have been more specifically defined based on financial accountability, as compared with previous standards based on oversight responsibility. Also, reporting certain component units discretely in the financial statements, rather than blended with the financial information of the other funds, is intended to make the financial statements of the primary government more meaningful to users.

2.03 The purpose of this chapter is to alert auditors to the major considerations of the reporting entity definition and related reporting matters. However, auditors should refer to GASB Cod. sec. 2100 and 2600 for a complete discussion of the standards and for illustrative financial statement formats. Auditors need to address these matters during the planning, testing, and reporting phases of the audit.

2.04 During the initial planning stages of an audit, the auditor should assess whether the governmental unit has identified all potential component units. To assist the auditor in determining that the client has identified correctly which component units should be included in the financial statements, the auditor should be familiar with the requirements and terminology in GASB Cod. sec. 2100 and 2600.

2.05 The determination of which potential component units should be included in the financial statements is not always a simple task. In some situations, the state attorney general, state auditor, auditor general, or legal counsel may need to be consulted. If component units are excluded from the financial statements of the governmental unit, the auditor should inform the client of the effect of the omission on the auditor's report.

⁶ Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. A component unit may be a governmental organization, a not-for-profit corporation, or a for-profit corporation.

2.06 It is also important to determine all potential component units early during the planning phase to ensure that the audit is properly coordinated and the materiality levels appropriately established (see chapter 3, “Planning the Audit,” paragraph 3.12 herein). Some component units may be audited by other auditors (see paragraph 3.10 herein). Delivery deadlines need to be established to ensure that audits of the component units are completed in time to be included in the financial statements of the primary government. Certain component units may also require special expertise, such as on health care, insurance, or actuarial matters. These specialized areas should be identified early to ensure that personnel with the required experience will be available when needed.

Financial Reporting Entity

2.07 The definition of the financial reporting entity is primarily based on the concept of financial accountability. Financial accountability exists if a primary government appoints a voting majority of an organization’s governing body, *and is either able to impose its will on that organization or there is a potential for the organization to provide a specific financial benefit to, or impose specific financial burdens on, the primary government.* Governmental units create separate organizations for a variety of reasons. Despite the outward appearance of autonomy, or separateness, these organizations are administered customarily by governing bodies that have been appointed by the elected officials of a primary government. Thus, the elected officials are accountable to citizens for their public policy decisions, regardless of whether those decisions are carried out directly by the elected officials through the operations of the primary government or by their designees through the operations of specially created organizations. This broad-based notion of accountability by elected officials leads to the underlying concept of the governmental financial reporting entity.

Applicability

2.08 The requirements of GASB Cod. sec. 2100 and 2600 apply at all levels to all state and local governments and to the financial reporting of the following:

- Primary governments
- Governmental joint ventures
- Jointly governed organizations
- Other stand-alone governments

The requirements apply whether the financial statements are those of a financial reporting entity or the separately issued financial statements of governmental component units. In addition, GASB Statement No. 14 should be applied to all governmental and nongovernmental component units when they are included in a governmental financial reporting entity.

2.09 The financial reporting entity consists of the following:

- The primary government
- Organizations for which the primary government is financially accountable
- Other organizations whose relationship with the primary government is so significant that the financial reporting entity’s financial statements would be misleading or incomplete if the organization were to be excluded

2.10 GASB Cod. sec. 2100.112 defines a primary government as any state government or general-purpose local government (for example, a municipality or county). A primary government is also a special-purpose government (for example, a school district or a park district) that meets *all* of the following criteria:

- It has a separately elected governing body
- It is legally separate
- It is fiscally independent

The primary government consists of all funds, organizations, institutions, agencies, departments, and offices that make up the legal entity. Therefore, auditors should assess whether all related financial information of the financial reporting entity is reported. GASB Cod. sec. 2100 provides guidance to assist auditors in determining separate legal standing and fiscal independence.

2.11 Component units are legally separate organizations (to include not-for-profit or for-profit corporations) for which elected officials of the primary government are financially accountable (to include organizations that are fiscally dependent). Auditors are referred to GASB Cod. sec. 2100 for a detailed discussion of various considerations related to the foregoing criteria. GASB Cod. sec. 2100.901 provides a flowchart as an aid for evaluating potential component units of a particular reporting entity.

Reporting

2.12 Auditors should determine that the financial statements of the reporting entity permit the reader to clearly distinguish between the primary government and its component units. Some component units have close relationships with the primary government, and their financial statements should be blended as if they were part of the primary government; however, most component unit financial statements will be discretely presented. GASB Cod. sec. 2600 provides standards and disclosure requirements for both types of presentations.

2.13 The auditor should also obtain assurance that the notes to the financial statements distinguish between information pertaining to the primary government (including its blended component units) and that of its discretely presented component units. GASB Cod. sec. 2600.130-.131 and J50 discuss disclosures of the reporting entity's relationships with certain organizations other than component units, including the following:

- Related organizations
- Joint ventures
- Jointly governed organizations
- Component units and related organizations with joint venture characteristics
- Pools
- Undivided interests
- Cost-sharing arrangements

The auditor needs to review carefully disclosure requirements for these types of related organizations.

Fund Structure

2.14 Within a primary government, the accounting systems and financial reports of a governmental unit are organized on a fund basis. Each fund is a

separate fiscal entity in the governmental unit, much the same as various corporate subsidiaries are fiscally separate in private enterprise. The separate funds are established by the governmental entity for specific fiscal accountability in accordance with statutes, laws, regulations, restrictions, or specific purposes.

Fund Categories

2.15 The auditor should refer to GASB Cod. sec. 1300 for the governmental principles of fund accounting for the seven major fund types and two account group categories. The following is a brief summary of the basic overall fund structure of a governmental unit:

- Fund types are—
 - Governmental funds, which include—
 - (a) General fund.
 - (b) Special revenue funds.
 - (c) Capital projects funds.
 - (d) Debt service funds.
 - Proprietary funds, which include—
 - (a) Enterprise funds.
 - (b) Internal service funds.
 - Fiduciary funds, which include trust and agency funds.
- Account groups, which include—
 - (a) General fixed assets account group.
 - (b) General long-term debt account group.
- Component units discretely presented.

Number of Funds

2.16 There is no specific number of funds that should be utilized by a governmental entity. GASB Cod. sec. 1300 states only that the entity “should establish and maintain those funds required by law and sound financial administration.” However, the same section indicates that governments shall report only one general fund.

2.17 The auditor should determine that separate funds are maintained and reported when required by law or other external restrictions. However, accounting principles generally do not require separate funds (unless legally mandated) to account for restricted resources, provided that applicable legal requirements can be appropriately satisfied (see GASB Cod. sec. 1300.107). The auditor also should recognize that those employed by the governmental entity’s funding sources will often interchange the terms *funds* and *accounts*; in most instances, the use of those terms does not necessitate a separate fund entity or bank account, as long as a separate accounting is provided for restricted resources.

Reporting Entity Presentation

2.18 The reporting entity principles included in GASB Cod. sec. 2600 require the preparers of financial statements to distinguish between the pri-

mary government, including its blended component units, and its discretely presented component units. These changes may affect the fund presentations in the financial statements. (Guidance on the determination of materiality is provided in paragraph 3.12 herein.) For example, special districts previously blended and reported within the special revenue funds (and perhaps even account groups), or municipal utilities previously blended and reported as enterprise funds, may require a discrete presentation.

2.19 GASB Cod. sec. 2100.902 through .920 and 2600.902 through .910 provide illustrative examples, disclosures, and financial statement formats that provide added guidance for the financial reporting entity and the related fund presentation. Additional guidance is provided in a GASB staff document, *Questions and Answers Guide to Implementation of GASB Statement No. 14 on the Financial Reporting Entity*.

Chapter 3

Planning the Audit

Introduction

3.01 SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), provides general guidance on the considerations and procedures applicable to planning and supervision of all audits. In planning an audit of a state or local governmental unit, the auditor should—

- Identify the engagement's reporting objectives.
- Identify the auditor's role as principal auditor, component unit auditor, or joint auditor.
- Consider the audit focus of governmental financial statements and level of materiality.
- Obtain an understanding of the governmental unit.
- Obtain an understanding of the internal control over financial reporting and perform a control risk assessment.
- Evaluate factors affecting the risk of financial statement misrepresentations.
- Establish the audit approach, including the development of an audit program.
- Communicate with the client concerning engagement details and auditor/client responsibilities, including the communication required by *Government Auditing Standards* discussed further in paragraph 3.04.
- Inquire whether there is a need for any special audits or reports.
- Assess management's identification of the laws and regulations that have a direct and material effect on the determination of amounts in the financial statements.
- Perform preliminary analytical procedures.
- Consider other matters affecting the conduct of the audit, including management representation letters, lawyer letters, the applicability of other audit and accounting guides, component unit disclosure issues, unresolved accounting and auditing issues, and auditor independence.

Planning the audit is required by GAAS, and the process continues throughout the audit. Early planning is useful in establishing the probable level and type of effort necessary to conduct the engagement.

3.02 SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310), states that the auditor should establish an understanding with the client regarding the services to be performed. Such understanding reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other party. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and the limitations of the engage-

ment. The auditor should document this understanding in the working papers, preferably through a written communication with the client. If the auditor believes an understanding with the client has not been established, he or she should decline to accept the engagement. SAS No. 83 includes a listing of the matters that should generally be included when the auditor establishes an understanding with the client regarding an audit of the financial statements. An engagement letter is useful in establishing the necessary understanding between the client and the independent auditor, and such a letter is recommended. In a governmental setting, those matters are typically included in a formal contract.

3.03 The client responsibilities can best be explained by having a preaudit conference with the auditee (see paragraphs 3.23 and 3.24). It is good practice to document the understandings from the preaudit conference in an engagement letter addressed to the officials having the authority to engage the auditor. Such an engagement letter should mitigate potential misunderstanding between the auditor and the client.

3.04 In addition to the requirements of SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), *Government Auditing Standards*, chapter 5, paragraphs 5.5 through 5.8 requires auditors to communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit. This communication may be oral or written. Auditors may use an engagement letter to communicate such information. If the information is communicated orally, auditors should document the communication in the working papers. Auditors should communicate the following information:

- a. The auditors' responsibilities in a financial statement audit, including their responsibilities for testing and reporting on internal control and compliance with laws and regulations.
- b. The nature of any additional testing of internal control and compliance required by laws and regulations. For example, auditors may be required to comply with the additional requirements of the Single Audit Act Amendments of 1996, OMB Circular A-133, or other state and local laws and regulations.

To help audit committees and other responsible parties understand the limitations of auditors' responsibilities for testing and reporting on internal control and compliance, auditors should contrast the responsibilities in *a* and *b* with other financial related audits of controls and compliance (such as an opinion on the internal control over financial reporting). See *Government Auditing Standards*, paragraphs 5.9 and 5.10, for further guidance.

Identification of the Engagement Reporting Objectives

3.05 Identification of the specific reports to be issued should be an early step in planning an audit. For example, in an audit or engagement conducted in accordance with GAAS, the auditor may be required to report on any or all of the following:

- GPFS of the reporting entity, including required supplementary information, where applicable

- Comprehensive annual financial report (CAFR) covering the GPFS and combining and individual fund and account group financial statements, schedules, and statistical tables. (The auditor may report on the combining and individual fund financial statements presented separately or in relation to the GPFS.)
- Financial statements of a component unit, including required supplementary information, where applicable
- Financial statements of a department or agency
- Individual fund financial statements
- Special reports on, for example, compliance with bond indentures, or requirements of federal or state grants, regulatory agencies, or state auditors

Chapter 18, “Auditor’s Reports on Basic or General-Purpose Financial Statements,” discusses and illustrates reporting on the government’s financial statements. Exhibit 18.1 illustrates the relationship that exists in the financial reporting pyramid.

3.06 The auditor may be engaged to expand the scope of the engagement for other purposes—for example, to issue single audit reports (the Single Audit Act Amendments of 1996) related to federal awards as described in SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (see appendix M), or to review the CAFR submitted to either the GFOA or the Association of School Business Officials (ASBO) to determine if the report meets their respective certificate program requirements. In all cases, care should be exercised to assure that the reporting requirements of the engagement are clearly defined, preferably in a written engagement letter or contract.

Determination of Principal Auditor

3.07 As previously discussed, the GASB Codification recognizes general-purpose financial statements as an appropriate reporting vehicle for governmental units. As discussed in GASB Cod. sec. 2100, related government activities or component units that meet the defined criteria are required to be included in the GPFS of the financial reporting entity. That requirement has resulted in the frequent inclusion of component units whose financial statements are audited by auditors other than those engaged by the primary government. In some cases the assets, liabilities, revenues, or expenditures (or expenses) of one or more component units may exceed those of the primary government. Those circumstances have raised questions about who is the principal auditor of the financial statements of the reporting entity. Paragraph .02 of SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543.02), requires a decision as to whether the auditor’s participation in the audit is sufficient to enable the auditor to serve as the principal auditor and to report as such on the financial statements.

3.08 Considering the requirements of SAS No. 1, section 543 (AICPA, *Professional Standards*, vol. 1, AU sec. 543) and the nature of governmental units and their financial statements, an auditor should meet both of the following criteria in order to serve as the principal auditor:

- a. Engagement by the primary government as the principal auditor of the financial reporting entity

- b. Responsibility for auditing at least the general fund, or the primary operating fund if no general fund exists, of the primary government

Having met the principal auditor criteria, the auditor of the primary government is required to exercise the responsibilities of that position. Those responsibilities include confirming the independence of the other auditors (see paragraphs 3.45 and 3.46) and evaluating any adjustment, combination, or reclassification of component unit financial data to conform to the presentation in the GPFS of the reporting entity.

3.09 In accordance with SAS No. 1, section 543, the principal auditor should decide whether to make reference in his or her opinion to the audit(s) of the other auditor(s). If the part of the audit that was done by another auditor is referred to, the disclosure of the magnitude of the portion of the financial statements audited by the other auditor should also include an identification of the fund types and account groups (if blended) or the component unit columns (if discrete). Examples A.12(A), "Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of an Organization, Function, or Activity by Other Auditors;" A.12(B), "Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements When One Fund or Component Unit Representing Less Than All of a Fund Type Has Been Audited by Other Auditors;" and A.13, "Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of *All* of a Fund Type by Other Auditors" in appendix A, "Illustrative Auditor's Reports," present illustrative auditor's reports for the principal auditor's reference to the audits of other auditors in various circumstances.

3.10 *Responsibilities of Component Unit Auditor.* The auditor of a component unit may or may not be the same as the auditor of the primary government. In those circumstances, it is important that an appropriate professional relationship be established between the two auditors. The auditor of the primary government (the principal auditor) assumes certain responsibilities under SAS No. 1, section 543. The component unit auditor may be required to facilitate the principal auditor's execution of professional responsibilities. In addition, the component unit auditor may be expected to participate in presenting financial statements of the component unit on a different basis of accounting or fiscal year not typically prepared by the component unit for its separate reporting. It is important that the auditors and their clients reach an early agreement on reporting responsibilities, including how any additional preparation and audit costs will be borne by the entities.

3.11 *Responsibilities as Joint Auditor.* With the encouragement of governments, certified public accounting (CPA) firms occasionally agree to perform audits on a joint venture or subcontract basis. Independent auditors participating in a joint audit should arrive at a formal understanding of their respective responsibilities, usually through a contract, including the following:

- Signing the audit report
- Determining the compensation of the parties
- Supervising the engagement
- Documenting the engagement in the working papers
- Establishing review procedures

The responsibility for signing the audit report usually dictates the extent of the working paper review and other professional requirements imposed on the participants. (See chapter 16, "State Governments," paragraphs 16.10 through 16.14 for a discussion of joint audits.)

Financial Statement Format and Materiality

3.12 GASB Cod. sec. 2200.101 states that every governmental unit should prepare and publish, as a matter of public record, a CAFR that encompasses all funds and account groups. The CAFR should contain (a) GPFS by fund type and account group, and (b) combining statements by fund type and individual fund statements. GASB Cod. sec. 2200 addresses various aspects of financial reporting, including the requirements applicable to the GPFS. GPFS are required to be presented in a combined statement format that presents fund types, and account groups, and discretely presented component units in side-by-side columns. The omission of an existing fund type, account group, or component unit from the GPFS is a departure from GAAP. Examples A.5 through A.7 in appendix A, “Illustrative Auditor’s Reports,” illustrate the report format in these circumstances when the departure from GAAP is material. Therefore, audit scope should be set and materiality evaluations should be applied at the fund type, account group, and discretely presented component unit column(s) when reporting on GPFS, or at the individual fund statement level when reporting on the GPFS, combining and individual fund financial statements in a CAFR.

3.13 With respect to the auditor’s reports on the GPFS, the omission of a fund type or account group, for any reason other than the nonexistence of the related fund type or account group, requires a qualification of the auditor’s report.

Understanding the Governmental Unit

3.14 Background information relating to the operations of the governmental unit should be obtained in order to provide a basis for subsequent audit planning procedures. Background information useful to planning may include the following:

- The composition of the reporting entity
- The form of government, for example, a legislative body with governor or mayor as the administrator versus a legislative body with an appointed manager
- Organizational structure, including the names and experience of top management
- Laws, statutes, and regulations governing the general operations of the governmental unit
- The nature of any joint ventures
- Factors affecting the continued functioning of the governmental unit, for example, the presence or absence of taxpayer initiatives that limit the taxing authority’s growth, expenditure growth, or the addition of incremental services
- The existence and functions of an audit committee or other group or individual with oversight responsibility for financial reporting
- Primary sources of revenue (for example, property taxes, appropriations, grants, contracts, service charges)
- Services provided by the governmental unit
- Services provided by separate governmental departments and independent entities (for example, hospitals, schools, redevelopment agencies) and their relationship to the governmental unit to be audited

- Number of employees by governmental function
- An assessment of accounting and financial reporting systems; if automated, a general understanding of the type of electronic data processing (EDP) equipment used, personnel involved, and similar background information, including software packages and operating systems
- The number and nature of funds and account groups
- Departures from GAAP in prior financial statements that could lead to report qualifications
- The nature of any compliance auditing requirements
- Special reporting requirements

3.15 The foregoing information generally can be obtained from authorizing statutes, charters, budget documents, recent official statements, prior comprehensive annual financial reports, the request for proposal, other documents, and discussions with key members of management.

Consideration of Internal Control Over Financial Reporting

3.16 As discussed in chapter 4, “Internal Control Over Financial Reporting,” the auditor is required to obtain an understanding of each of the five components of internal control (control environment, risk assessment, control activities, information and communication, and monitoring) that is sufficient to plan the audit by performing procedures to understand (a) the design of controls relevant to an audit of financial statements, and (b) whether they have been placed in operation. In deciding where to focus the procedures undertaken to gain an understanding of the internal control, the auditor should consider, among other matters, judgments about materiality for various account balances and transaction classes and the information obtained from the evaluation of the risk factors described in paragraph 3.18.

3.17 After obtaining this understanding, the auditor must assess and document the control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The independent auditor uses the knowledge he or she has gained about internal control and the assessed level of control risk in determining the nature, timing, and extent of substantive tests on financial statement amounts.

Factors Affecting the Risk of Financial Statement Misrepresentation

3.18 In developing an audit plan, the auditor should consider factors influencing the risk of errors, fraud, or illegal acts causing financial statements to be materially misstated. This should include an evaluation of the following factors:

- The existence of laws, rules, and regulations that may have a direct and material effect on amounts reported in the financial statements
- Unusual or unexpected transactions, events, amounts, ratios, or trends noted as a result of analytical procedures
- The existence of material accounting estimates

- The existence of many contentious or difficult accounting issues
- The existence of significant difficult-to-audit transactions
- The appearance of an unduly aggressive attitude on the part of management toward financial reporting
- The management's poor reputation in the governmental management community
- The circumstance that the governmental unit is a new client and sufficient prior audit information is not available from the predecessor auditor (see SAS No. 84, *Communications Between Predecessor and Successor Auditors* [AICPA, *Professional Standards*, vol. 1, AU sec. 315])
- The potential for management misrepresentation
- The susceptibility of assets to unauthorized use or disposition
- The effectiveness of the overall financial controls, including the ability to operate within approved budgets and issue timely and accurate financial reports
- The appropriate segregation of duties and responsibilities
- The dependence of the governmental unit on one or more individuals to operate key programs or manage the budget or financial reporting function
- The effectiveness of the internal audit function
- Turnover of key personnel
- Qualifications of key personnel
- Federal or state requirements for expanded audit scope
- Qualifications in auditors' reports for prior years
- The reduction or elimination of federal or state grant funds to finance key local programs
- The ability of key subsidiary accounting systems to produce data necessary to support financial statements
- Decentralized or centralized records

Auditors should also refer to SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), for guidance on fraud risk factors and assessing the risk of material misstatement due to fraud (see also paragraphs 5.24 through 5.28). Auditors may also wish to refer to the AICPA practice aid titled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which includes specific nonauthoritative guidance on applying the concepts of SAS No. 82 to several industries, including government. It also includes example industry-specific fraud risk factors.

Audit Approach

3.19 The auditor should design an effective audit approach when planning the engagement. Because governmental units often maintain numerous funds and account groups, audit tests are most efficient if they are designed to avoid repetitive procedures. However, if one or more activities of the governmental unit are operated autonomously, they may need to be tested separately.

3.20 The information obtained from the above-mentioned procedures should be used to evaluate the risk that material misstatements may exist in

the financial statements and to establish acceptable levels of audit risk in view of the perceived levels of detection risk. These evaluations should be used to develop an audit program.

3.21 The auditor should consider the nature, timing, and extent of the work to be performed and develop an audit program. The auditor should be aware that as the audit progresses, the audit program may need to be modified because of changed conditions, for example, unexpected results from tests of the operating effectiveness of internal control over financial reporting, the presence of new information, or unanticipated activities of the government. SAS No. 22, as amended by SAS No. 77, *Amendments to SAS No. 22, Planning and Supervision, No. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, and No. 62, Special Reports (AICPA, Professional Standards, vol. 1, AU secs. 311, 341, and 623)*; SAS No. 41, *Working Papers (AICPA, Professional Standards, vol. 1, AU sec. 339)*; and SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55 (AICPA, Professional Standards, vol. 1, AU sec. 319)*; provide guidance on audit programs and other working paper documentation.

3.22 A preliminary audit planning memorandum may be prepared describing the overall approach to the audit, including the following:

- Audit objectives
- Staffing levels and staff responsibilities
- Use of analytical procedures
- Responsibility for and extent of supervision
- Budgeted hours and completion dates for audit segments
- Materiality levels used for planning purposes
- Risk assessments relating to the understanding of internal control over financial reporting obtained to plan the audit
- Guidelines relating to working paper form and content
- Use of specialists

The audit planning memorandum may be used as a basis for audit staff planning conferences as well as a means of monitoring the progress of the audit.

Preaudit Communication With the Client

3.23 It may be desirable to hold a preaudit conference with the client to discuss the responsibilities of both the client and the auditor. Key elements of the preaudit conference include—

- Identification of audit staff.
- The independent auditor's responsibility for communicating reportable conditions under SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit (AICPA, Professional Standards, vol. 1, AU sec. 325)*.
- Audit timing, including dates for the following:
 - Availability of records.
 - The start of the audit, including the start of an alternative course of action should the records not become available as planned.
 - The required delivery of the report.

- Reports to be provided by the auditor pursuant to the terms of the engagement.
- Purpose, nature, scope, and limitations of the audit.
- Applicable audit standards and guidance, including the auditor's responsibility for communicating with management if the auditor becomes aware that the entity is subject to an audit requirement that is not encompassed in the terms of the engagement.
- Communication of matters required by paragraphs 5.5 through 5.8 of *Government Auditing Standards* (see paragraph 3.04).
- The auditor's responsibilities for—
 - Discovering and reporting fraud and illegal acts, contractual compliance violations, and questioned costs.
 - Communicating certain matters to the audit committee or other party responsible for oversight of the financial reporting process.
 - Preparing the annual report or other involvement in conformance with any ASBO and GFOA certificate program requirements.
- The client's responsibility for—
 - Financial statement assertions and a management representation letter accepting such responsibilities.
 - The internal control over financial reporting.
 - Identifying all laws, rules, and regulations that may have a direct and material effect on the financial statement amounts and for disclosing all instances of noncompliance.
- The auditor's expectations concerning the availability of lawyer letters.
- Identification of federal and state financial assistance programs if a single audit or program audit is to be performed.
- Internal audit and clerical assistance the auditor expects to receive from the client.
- Nature and extent of any additional audit tests to be performed at the client's request.
- Understanding of fee and billing arrangements.

3.24 These preaudit conference understandings may be communicated in an engagement letter addressed to the board or official with the authority to engage the auditor. Auditors should refer to SAS No. 83 for additional information on establishing an understanding with the client (see paragraph 3.02).

Determining Whether an Additional Audit Is to Be Performed

3.25 As part of the planning process, the auditor needs to be aware of whether the entity is subject to additional audit requirements that are not encompassed by the terms of the engagement. If the auditor becomes aware that an audit in accordance with GAAS will not satisfy the relevant legal, regulatory, or contractual requirement, the auditor should make management aware of the type of audit that is required (for example, an audit in accordance with *Government Auditing Standards* or a single audit in accordance with OMB Circular A-133). (See chapter 5, "Testing and Reporting on Compliance With Laws and Regulations," paragraphs 5.05 and 5.06 for further discussion of the auditor's responsibilities in this situation.)

Determining Compliance Requirements

3.26 Paragraphs 3 through 7 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801.03 through .07), provides guidance on the auditor's responsibility for testing compliance requirements that could have a direct and material effect on the financial statements. In planning the audit, 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 an entity's financial statements. The auditor should also assess whether management has identified laws and regulations that have a direct and material effect on the determination of amounts in an entity's financial statements and obtain an understanding of the possible effects on the financial statements of such laws and regulations.

Performing Analytical Procedures

3.27 In planning the audit, the auditor should perform analytical procedures to identify significant matters that may require audit emphasis. However, overall analytical procedures are generally less effective when applied to the combined financial statements. Such procedures should be directed at a level sufficient to understand the effect of significant events or actions taken by management. See SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329).

Developing Audit Programs

3.28 In planning an audit, according to SAS No. 22, as amended by SAS No. 77, an auditor should prepare a written audit program or set of programs. Efficient and effective audit programs incorporate consideration of financial statement assertions, specific audit objectives, and appropriate audit procedures to achieve the specific objectives.

3.29 The GASB Codification contains the accounting and reporting standards for governmental units. Part II, "The State and Local Government Audit—Governmental Funds and Account Groups" and Part III, "The State and Local Government Audit—Proprietary and Fiduciary Funds," herein, set forth general financial statement assertions, audit objectives, and audit procedures that may be considered in developing audit programs. Appendix B of this guide, "Illustrative Internal Control Questions—State and Local Governmental Units," contains a list of illustrative internal control questions that an auditor might raise concerning a state or local government. The auditor plans his or her audit using the GASB Codification and this guide to meet the objectives of each specific audit engagement.

3.30 *Financial Statement Assertions.* In forming an opinion on the financial statements, "Assertions," according to paragraph 3 of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.03), "are representations by management that are embodied in financial statement components." Assertions can be classified in the following broad categories:

- ***Existence or Occurrence.*** Reported assets and liabilities actually existed at the balance-sheet date and transactions reported in the operating statement actually occurred during the period covered.

- **Completeness.** All transactions and accounts that should be included in the financial statements are included, and there are no undisclosed assets, liabilities, or transactions.
- **Rights and Obligations.** The entity has rights to the assets, and the liabilities are obligations of the entity at a given date.
- **Valuation or Allocation.** The assets, liabilities, revenues, and expenditures/expenses are included in the financial statements at an appropriate amount.
- **Presentation and Disclosures.** The assets, liabilities, revenues, and expenditures/expenses are properly classified, described, and disclosed in the financial statements.

3.31 Developing Audit Objectives. An auditor develops specific audit objectives to obtain evidential matter to support the financial statement assertions. An audit objective is, in effect, an assertion translated into terms relevant to a specific account.

3.32 Selecting Audit Procedures. The basic requirements for selection of audit procedures are set forth in SAS No. 31 (see “Use of Assertions in Developing Audit Objectives and Designing Substantive Tests,” AU sec. 326.13).

Other Matters

3.33 Certain other matters unique to audits of governmental units are also discussed in this chapter because of their potential relevance to the audit planning process. Those matters include working paper documentation, audit follow-up, inquiries of a client’s lawyer (lawyer letters), the applicability of other AICPA audit and accounting guides, component unit disclosure issues, unresolved accounting and auditing issues, and auditor independence. Also, because governmental administration changes are common, the independent auditor may have difficulty obtaining representations from management because the officials have left the employ of the government. SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), discusses auditors’ responsibilities for obtaining written representations in an audit engagement when current management was not present during the period under audit. In this situation, SAS No. 85 states that auditors should obtain written representations from current management on all periods covered in their report. The specific representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. Failure or inability to obtain written representations from management may result in a limitation on the scope of the audit sufficient to preclude the auditor from expressing an unqualified opinion. See SAS No. 85 and chapter 17, “Concluding the Audit,” for additional discussion of management representation letters.

Working Paper Documentation

3.34 SAS No. 41 provides guidance on the preparation and maintenance of working papers as required by GAAS. Also, Appendix K contains an Interpretation of SAS No. 41 titled, “Providing Access to or Photocopies of Working Papers to a Regulator.” That interpretation provides guidance on responding to requests by governmental agencies (regulators) that auditors provide them with access to audit working papers.

3.35 *Government Auditing Standards* adds an additional working paper standard for financial audits that requires working papers to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments. Specifically, *Government Auditing Standards* states that working papers should contain—

- a. The objectives, scope, and methodology, including any sampling criteria used.
- b. Documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records.
- c. Evidence of supervisory reviews of the work performed.

Audit Follow-Up

3.36 *Government Auditing Standards* includes an additional field work standard in the area of audit follow-up. Paragraph 4.10 of *Government Auditing Standards* states: "Auditors should follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. They should do this to determine whether the auditee has taken timely and appropriate corrective actions. Auditors should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit."

Lawyer Letters

3.37 Lawyer letters of the type requested in commercial audits should be requested (see SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* [AICPA, *Professional Standards*, vol. 1, AU sec. 337]). They may be requested, for example, from the city attorney or the state attorney general, and outside counsel used on significant matters. If the government's chief legal officer or its outside legal counsel is unwilling or unable to provide all the information the auditor needs to form a conclusion on litigation, claims, and assessments, the auditor should plan early in the engagement to take the appropriate steps and discuss with the client the qualification that may be necessary when expressing an opinion. If inside counsel provides the assessment of litigation, claims, and assessments, Interpretation No. 8, "Use of the Client's Inside Counsel in the Evaluation of Litigation, Claims, and Assessments," of SAS No. 12 should be considered (AICPA, *Professional Standards*, vol. 1, AU sec. 9337.24).

Applicability of Other AICPA Audit Guidance

3.38 Large governments may have a variety of component units, and planning should involve not only identifying applicable component units of the reporting entity, but also the accounting principles and financial reporting practices that should be used by specific component units. In addition to this guide, four other guides have been issued by the AICPA that address organizations involved in activities often conducted by units of government. Their applicability in a governmental environment should be determined. The following discussion provides guidance until these issues are further addressed by the GASB.

3.39 Audits of Health Care Organizations. Government-operated health care entities generally should be reported as enterprise funds in accordance with the requirements of the AICPA Audit and Accounting Guide *Health Care Organizations*.

3.40 Audits of Colleges and Universities. See chapter 1, "Overview," paragraph 1.05, herein, for a discussion of the applicability of the AICPA Industry Audit Guide *Audits of Colleges and Universities*.

3.41 Audits of Certain Nonprofit Organizations. Some governmental units conduct activities such as operating libraries, museums, cemeteries, and zoological parks. The AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations* may be useful in identifying audit objectives and related audit procedures. (Auditors should note that although *Audits of Certain Nonprofit Organizations* has been superseded by the recently issued Audit and Accounting Guide *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment.) See chapter 1, "Overview," paragraph 1.08, herein, for additional information.

3.42 Audits of Employee Benefit Plans. Public employee retirement systems (PERS) are similar to private sector plans in many respects. As a result, the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* may be useful in identifying audit objectives and related audit procedures.

Disclosure Issues

3.43 As described in the health care and college and university audit and accounting guides, financial statements of those entities usually employ a multiple-fund-type structure often including, among others, general unrestricted funds, restricted funds, endowment or trust funds, and plant funds. If such an entity is included in a government's financial statements, its financial position and results of operations included in the GPFs of the government should be based on all of its financial activity in accordance with GASB Cod. sec. 2600. Significant disclosures that might be obscured, such as the extent of restricted assets and liabilities, should be provided in the notes to the financial statements or through alternative statement classifications. When separate financial statements for the component unit are issued, the notes thereto describing the separate activities should describe clearly the relationship of the component unit to the primary government.

Unresolved Accounting and Auditing Issues

3.44 As of the date of this guide, there are a number of projects under way by GASB and various government agencies that could establish new standards and principles or modify existing ones. Therefore, when planning and conducting a financial statement audit, the auditor should refer to the most recent pronouncements of the GASB, the AICPA, and the GAO, and other pertinent government agencies. The auditor should also refer to the annual AICPA Audit Risk Alert *State and Local Governmental Developments* for further information about projects that may be under consideration.

External Auditor Independence

3.45 GASB Cod. sec. 2100 requires the financial statements of many agencies, organizations, and authorities (component units) previously consid-

ered to be autonomous to be combined with the financial statements of another governmental unit (primary government) to form a financial reporting entity. Ethics Interpretation 101-10 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12) discusses the effect on independence of relationships with entities included in governmental financial statements. Among other things, the Interpretation requires the following:

- Auditors issuing a report on the general-purpose financial statements of the financial reporting entity must be independent of the financial reporting entity, as defined in the Interpretation. However, independence is not required with respect to a related organization if the financial reporting entity is not financially accountable for the organization and the required disclosure does not include financial information (for example, the ability to appoint or the appointment of governing board members).
- Auditors who are auditing the financial statements of a material fund type, fund, account group, or component unit of the financial reporting entity or entity that should be disclosed in the notes to the general-purpose financial statements of the financial reporting entity but are not auditing the primary government, should be independent with respect to those financial statements and those of the primary government. Auditors are not required to be independent of other fund types, funds, account groups, or component units of the financial reporting entity or entities that should be disclosed in the notes to the general-purpose financial statements of the financial reporting entity provided they are not financially accountable for or to the auditee organization or cannot significantly influence the auditee organization through financial transactions or through common policy-making individuals or governing board membership.
- Auditors who are not auditing the primary government but are auditing the financial statements of one or more fund types, funds, account groups, or component units of the financial reporting entity or entities that should be disclosed in the notes to the general-purpose financial statements of the financial reporting entity that alone or in the aggregate are immaterial to the general-purpose financial statements, should be independent with respect to those financial statements and should not be associated with the primary government in any capacity described in Interpretation 101-1-B, *Interpretation of Rule 101* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02). If auditors are auditing immaterial fund types, funds, account groups, or component units of the financial reporting entity or entities that should be disclosed in the notes to the general-purpose financial statements of the financial reporting entity that, when aggregated, are material to the financial reporting entity, auditors should be independent of those financial statements and the primary government.

3.46 An auditor expressing an opinion on the financial statements of a governmental reporting entity should take reasonable steps to confirm the independence of auditors of fund types, funds, account groups, component units, or entities that should be disclosed in the notes to the general-purpose financial statements of the financial reporting entity in accordance with SAS No. 1, section 543.

3.47 Auditors are also reminded of Ethics Ruling No. 102, *Member's Indemnification of a Client* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.204 and .205), that was issued in January 1996. This ruling states that au-

ditors should not enter into agreements that would require them to indemnify their client for damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to client acts, or their independence will be impaired. The use of such clauses by state and local governments in requests for proposals (RFP) and audit contracts have been on the increase. Therefore, auditors should carefully review RFPs and audit proposals for such clauses before entering into them.

Chapter 4

Internal Control Over Financial Reporting

Introduction

4.01 This chapter addresses the auditor's responsibility for consideration of internal control over financial reporting in audits of financial statements of governmental entities. SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, discusses the auditor's consideration of internal control over compliance for major programs in a single audit (see appendix M).

Responsibilities Under Generally Accepted Auditing Standards

4.02 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent auditor's consideration of an entity's internal control in an audit of financial statements in accordance with GAAS, defines internal control, describes the objectives and components of internal control, and explains how an auditor should consider internal control in planning and performing an audit. When obtaining an understanding of internal control over financial reporting and assessing control risk for the assertions embodied in the financial statements, the auditor should refer to SAS No. 55, as amended by SAS No. 78, and to the guidance in this chapter.

Definition of Internal Control

4.03 The definition of internal control in SAS No. 55, as amended by SAS No. 78, is consistent with the definition and description of internal control contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. The definition is as follows:

Internal control means a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

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

Control Objectives

4.04 The three categories of control objectives described previously are what an entity strives to achieve. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs

of the entity and others regarding each separate purpose. In general, controls that are relevant to an audit of financial statements pertain to the entity's objective of the reliability of financial reporting and involve the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP or a comprehensive basis of accounting other than GAAP.⁷ However, controls pertaining to the operations and compliance objectives may also be relevant to a financial statement audit to the extent that they pertain to data the auditor evaluates or uses in applying auditing procedures to the financial statements. Controls relevant to an audit of the financial statements are referred to collectively in this guide as "internal control over financial reporting" and are encompassed in the reporting on internal control required by *Government Auditing Standards* (see paragraphs 4.31 through 4.34 and 18.57 through 18.62).

Components of Internal Control

4.05 The five components of internal control are the control environment, risk assessment, control activities, information and communication, and monitoring (see paragraphs 4.06 through 4.18 for a detailed description of each component). SAS No. 55, as amended by SAS No. 78, requires the auditor to obtain an understanding of each of those components that is sufficient to plan the audit by performing procedures to understand (a) the design of controls relevant to an audit of financial statements and (b) whether they have been placed in operation. In audits of financial statements, this understanding incorporates knowledge about the design of controls relevant to compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts, as well as knowledge about whether they have been placed in operation. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. 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 five components of internal control (see also paragraphs 4.25 and 4.26). 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 address matters such as organizational goals and objectives, operating functions, and regulatory requirements

4.06 *Control Environment.* The control environment sets the tone of a governmental entity, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. The auditor should obtain sufficient knowledge of the control environment to understand management's and the governing body's attitude, awareness, and actions concerning the control environment, considering both the substance of controls and their collective effect. The auditor should concen-

⁷ A comprehensive basis of accounting other than GAAP is defined in paragraph 4 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04).

trate on the substance of controls rather than their form because controls may be established but not acted upon. For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on. Similarly, management may establish a formal code of conduct but act in a manner that condones violations of that code. When obtaining an understanding of the control environment, the auditor considers the collective effect on the control environment of strengths and weaknesses in various control environment factors. Management's strengths and weaknesses may have a pervasive effect on internal control (see paragraphs 4.35 through 4.42 for particular industry characteristics affecting the control environment).

4.07 Risk Assessment. A governmental entity's risk assessment for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with GAAP. For example, risk assessment may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

4.08 Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Risks can arise or change due to circumstances such as the following:

- Changes in operating environment
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New lines, products, or activities
- Restructurings
- Accounting pronouncements

4.09 The auditor should obtain sufficient knowledge of the entity's risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides about actions to address those risks. This knowledge might include understanding how management identifies risks, estimates the significance of the risks, assesses the likelihood of their occurrence, and relates them to financial reporting.

4.10 An entity's risk assessment differs from the auditor's consideration of audit risk in a financial statement audit. The purpose of an entity's risk assessment is to identify, analyze, and manage risks that affect entity objectives. In a financial statement audit, the auditor assesses inherent and control risks to evaluate the likelihood that material misstatements could occur in the financial statements.

4.11 Control Activities. Control activities are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the governmental entity's objectives. Control activities have various objectives and are applied at various organizational and functional levels. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- Performance reviews
- Information processing
- Physical controls
- Segregation of duties

4.12 The auditor should obtain an understanding of those control activities relevant to planning the audit. As the auditor obtains an understanding of the other components he or she is also likely to obtain knowledge about some control activities. For example, in obtaining an understanding of the documents, records, and processing steps in the financial reporting information system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control activities obtained from the understanding of the other components in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities to plan the audit. Ordinarily, audit planning does not require an understanding of the control activities related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them.

4.13 *Information and Communication.* The information system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to record, process, summarize, and report governmental entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. The quality of system-generated information affects management's ability to make appropriate decisions in controlling the entity's activities and to prepare reliable financial reports.

4.14 Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

4.15 The auditor should obtain sufficient knowledge of the information system relevant to financial reporting to understand—

- The classes of transactions in the governmental entity's operations that are significant to the financial statements.
- How those transactions are initiated.
- The accounting records, supporting information, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including electronic means (such as computers and electronic data interchange) used to transmit, process, maintain, and access information.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

In addition, the auditor should obtain sufficient knowledge of the means the entity uses to communicate financial reporting roles and responsibilities and significant matters relating to financial reporting.

4.16 *Monitoring.* An important management responsibility is to establish and maintain internal control. Management monitors controls to consider whether they are operating as intended and that they are modified as appropriate for changes in conditions.

4.17 Monitoring is a process that assesses the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. This process is accomplished through ongoing activities, separate evaluations or by various combinations of the two. In many governmental entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. Monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

4.18 The auditor should obtain sufficient knowledge of the major types of activities the entity uses to monitor internal control over financial reporting, including how those activities are used to initiate corrective actions. When obtaining an understanding of the internal audit function, the auditor should follow the guidance in paragraphs 4 through 8 of SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322.04–.08). See also paragraphs 4.46 through 4.48.

Relationship Between Objectives and Components

4.19 There is a direct relationship between the three categories of control objectives (what an entity strives to achieve) and the control components (what is needed to achieve the objectives). Although an entity's internal control addresses objectives in each of the categories referred to in the definition of internal control in paragraph 4.04, not all of these objectives and related controls are relevant to an audit of the entity's financial statements.

Safeguarding of Assets

4.20 Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. In obtaining an understanding of each of the components of internal control to plan the audit, the auditor's consideration of safeguarding controls is generally limited to those relevant to the reliability of financial reporting. For example, use of a lockbox system for collecting cash or passwords for limiting access to accounts receivable data files may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit. See also paragraph 4.29 for a discussion of the additional *Government Auditing Standards* guidance on safeguarding controls.

Understanding Internal Control

4.21 In making a judgment about the understanding of internal control necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatement that could occur, the risk that such misstatements may occur, and the factors that influence the design of substantive tests to detect the occurrence of misstatements. Other sources of such knowledge include previous audits and the understanding of the government environment. The auditor also considers assessments of inherent risk, judgments about materiality, and the complexity and sophistication of the government's operations and systems, including whether the method of controlling information processing is based on manual procedures independent of

the computer or is highly dependent on computerized controls. As the operations and systems of an entity become more complex and sophisticated, it may be necessary to devote more attention to internal control components to obtain the understanding of them that is necessary to design effective substantive tests.

Procedures to Obtain Understanding

4.22 In obtaining an understanding of controls that are relevant to audit planning, the auditor should perform procedures to provide sufficient knowledge of the design of the relevant controls pertaining to each of the five internal control components and whether they have been placed in operation. This knowledge is ordinarily obtained through previous experience with the governmental entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular control, and the nature of the entity's documentation of specific controls.

4.23 The auditor's assessments of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of internal control.

Documentation of Understanding

4.24 The auditor should document the understanding of the governmental entity's internal control components obtained to plan the audit. The form and extent of this documentation are influenced by the size and complexity of the entity, as well as the nature of the entity's internal control. For example, documentation of the understanding of the internal control of a large complex government may include flowcharts, questionnaires, or decision tables. For a small government, however, documentation in the form of a memorandum may be sufficient. Generally, the more complex the internal control and the more extensive the procedures performed, the more extensive the auditor's documentation should be.

Assessing Control Risk

4.25 After acquiring an understanding of internal control over financial reporting, the independent auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements (see also paragraph 4.05). Control risk is defined by SAS No. 55, as amended by SAS No. 78, as the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control. Control risk may be assessed at the maximum level for some or all assertions because controls are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, for purposes of audit efficiency, the auditor may plan to assess control risk at below the maximum level by performing tests of controls to evaluate the effectiveness of controls relevant

to specific financial statement assertions. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls. After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient. Auditors should refer to paragraphs 45 through 78 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.45 through .78), for further guidance on the consideration of internal control in assessing control risk, the relationship of the understanding to assessing control risk, and the evidential matter needed to support the assessed level of control risk.

4.26 In acquiring an understanding of internal control, the auditor must consider the computer controls as well as the controls over the manual portions of the system. When an entity uses a service organization to process its transactions, SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance to the auditor in considering the effect of the service organization on the internal control of the entity.

Communication Requirements

4.27 SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), provides guidance in identifying and reporting conditions that relate to an entity's internal control observed during an audit of financial statements. In addition to providing guidance on communicating reportable conditions and identifying material weaknesses in the internal control over financial reporting, SAS No. 60 states that because timely communication may be important, the auditor may choose to communicate significant matters related to internal control over financial reporting during the course of the audit rather than after the audit is concluded. The auditor should consult the guidance in SAS No. 60 for guidance on identifying and reporting conditions that relate to an entity's internal control over financial reporting observed during an audit of financial statements. The auditor should also consult the guidance in SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), for required communications to persons who have responsibility for the oversight of the financial reporting process (see also paragraph 3.04).

Responsibilities Under Government Auditing Standards

4.28 In an audit in accordance with *Government Auditing Standards*, the auditor has considerations beyond those in a GAAS audit related to internal control over financial reporting. Paragraphs 4.29 through 4.34 describe the additional *Government Auditing Standards* considerations.

Fieldwork

4.29 *Government Auditing Standards* does not prescribe any additional fieldwork standards with respect to the auditor's consideration of internal con-

trol over financial reporting beyond those required in an audit conducted in accordance with GAAS. However, paragraphs 4.22 through 4.33 of *Government Auditing Standards* provide guidance on four aspects of internal control over financial reporting that are important to the judgments auditors make about audit risk and about the evidence needed to support their opinion on the financial statements. These aspects are summarized as follows:

- *Control environment.* Auditors' judgments about the control environment may influence (either positively or negatively) judgments about specific control procedures.
- *Safeguarding controls.* These are the controls that prevent or timely detect unauthorized transactions and unauthorized access to assets resulting in possible losses that are material to the financial statements. Therefore, the understanding of safeguarding controls assists auditors in planning the audit to detect material misappropriations as well as to assess other risks that the financial statements could be materially misstated.
- *Controls over compliance with laws and regulations.* These are important to auditors in identifying the types of potential misstatements that could occur and the factors that could affect the risk of material misstatement. Such information can help 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.
- *Control risk assessments.* These are important in determining the nature, timing, and extent of the audit tests to be performed. *Government Auditing Standards* reminds auditors that when control risk is assessed below the maximum for a given financial statement assertion, the need for evidence from substantive tests of that assertion is reduced. Auditors are not required to assess control risk below the maximum and to rely on controls. However, auditors may find it efficient to do so for larger entities or those with complex operations. The auditors' ability to rely on controls is directly related to the evidence obtained to show that the controls work. Auditors may find it necessary to reconsider assessments of control risk when substantive tests detect misstatements.

4.30 The auditor should consider this guidance as it relates to the consideration of the entity's internal control over financial reporting in the audit of the financial statements.

Reporting

4.31 *Government Auditing Standards*, however, does require the auditor to report on internal control. Written reporting on internal control matters under *Government Auditing Standards* is based on the auditor's consideration of internal control over financial reporting as required by SAS No. 55, as amended by SAS No. 78. The report does not express an opinion on the entity's internal control over financial reporting, but rather describes the extent of the work performed, as required by SAS No. 55, as amended by SAS No. 78. The report includes the requirements of SAS No. 60, as well as the additional requirements of *Government Auditing Standards*. See paragraphs 4.32 through 4.34 and 18.57 through 18.62 (includes the basic elements of the required reporting) for further guidance on reporting under *Government Auditing Standards*.

4.32 With regard to matters noted in an audit that relate to internal control over financial reporting, paragraph 5.26 of *Government Auditing Standards* requires auditors to report deficiencies in internal control that they consider to be reportable conditions as defined by SAS No. 60. Paragraph 17 of SAS No. 60 prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. The illustrative report in example A.16 of appendix A provides recommended language that satisfies the requirements of *Government Auditing Standards* when no reportable conditions are noted during an audit. In reporting reportable conditions, auditors are required to identify those that are individually or cumulatively material weaknesses. Auditors should follow the report contents standards in chapter 7 of *Government Auditing Standards* when reporting reportable conditions or material weaknesses. The illustrative report in example A.16(A) of appendix A provides recommended language that satisfies the requirements of *Government Auditing Standards* when reportable conditions (whether or not they are considered to be material weaknesses) are noted during an audit.

4.33 Paragraph 5.28 of *Government Auditing Standards* states that when auditors detect deficiencies in internal control that are not reportable conditions, they should communicate those deficiencies to the entity, preferably in writing. If the auditors have communicated those deficiencies in internal control in a management letter to top management, they should refer to that management letter when they report on internal control (examples A.16 and A.16(A) of appendix A illustrate such a reference to the management letter). All communications to the entity about deficiencies in internal control should be documented in the working papers.

4.34 The following table summarizes the differences between SAS No. 60 and *Government Auditing Standards* with respect to reporting internal control matters.

| | <i>Government Auditing Standards</i> | SAS No. 60 |
|---|--------------------------------------|--|
| When is reporting required? | In every financial statement audit | When reportable conditions are noted |
| What is the form of the report? | Written | Oral or written, preferably in writing |
| Should the auditor separately identify those reportable conditions that are significant enough to be material weaknesses? | Yes | Permitted but not required |

Industry Characteristics Affecting the Control Environment

4.35 Government operations include a number of characteristics and internal control features that differ from those in the private sector and that may significantly affect the control environment, such as the following:

- Budget and appropriation systems
- Encumbrance systems
- Personnel control systems

- Procurement and contracting systems
- Grants monitoring/management
- Management

Budget and Appropriation Systems

4.36 Many government budgetary control systems have two primary objectives: (a) to determine that the proposed expenditures are allowed by the budget, and (b) to make sure that the proposed expenditures do not exceed budgeted and appropriated amounts. The budget and appropriation process often provides substantial direction and control over expenditures. Public budget hearings permit the press and public interest groups to influence anticipated levels of expenditures. Once adopted and appropriated, the budget becomes the expenditure authorization for operations. (See chapter 6, “The Budget,” for additional internal control considerations related to the budget process.)

Encumbrance Systems

4.37 Encumbrances frequently are recorded in the accounting system. Recording encumbrances at the time of a legal obligation (generally when a contract is executed or a purchase order is placed with a vendor) rather than when the goods or services are received (when the actual payment liability is incurred) provides an additional level of control. Some governments extend this control to recording commitments (preencumbrances) when there is an intent to enter into a legal obligation. Depending on the applicable laws and regulations, encumbrances may expire at fiscal year end. Commitments almost always expire at the end of each year.

Personnel Control Systems

4.38 Within most units of government, the procedures required to add or delete personnel from the organization’s payroll usually are well established. Union contracts, complex civil service regulations, or position classification systems designed to provide equity in job assignments, job protection, and other security to employees, require the implementation of specific controls. When coupled with budgetary controls, which are often in the form of position and salary ceiling limits, they reduce opportunities for discretionary hiring and termination. However, the position classification and control system requirements do not achieve their objectives unless they are executed properly and are linked to the payroll accounting system. Moreover, special units of government, such as public authorities, often are not under the same stringent controls as primary governmental units.

Procurement and Contracting Systems

4.39 Procurement techniques and the types of contracts and agreements used to acquire goods and services in governments frequently exceed the requirements of the private sector. Regulations surrounding the administration and use of procurement procedures by governments usually permit far less latitude and discretion than that commonly existing in the private sector. Because governmental procurement procedures usually provide for (a) public notice of procurement opportunities, (b) disclosure of procurement evaluation

procedures, and (c) bidding or negotiation procedures, significant procurements in government are usually exposed to a high level of public scrutiny. Each of these procedures may enhance the internal control of governmental units.

Management

4.40 The administration of a governmental entity usually has executive and legislative components; in many cases, there is a judicial component as well. The executive branch of a government is responsible for instituting and maintaining a satisfactory internal control for operations. This internal control should conform to the laws and regulations established by the legislative component. In addition, the judicial component frequently is quasi-independent from these other components. In a number of instances, for example, in some county governments, the courts have direct responsibility for their financial systems.

4.41 Management's awareness of and attitude toward internal control is part of the control environment that the auditor should evaluate early in an audit engagement. Management should understand its responsibility to implement and maintain adequate internal control and should—

- Initiate procedures to detect areas of operation that are particularly vulnerable to errors, fraud, and the misuse of assets, or circumstances that may adversely affect the reliability of the government's financial statements.
- Establish procedures to monitor and evaluate internal control (see paragraphs 4.16 through 4.18 above).
- Institute timely action to correct identified internal control weaknesses.

4.42 Management's perception of its responsibilities for the control environment can significantly affect the conduct of an audit.

Influence of Other Entities on Internal Control

4.43 Individuals and organizations, such as grantor agencies and internal auditors, may affect internal control in a governmental organization.

Grantor Agencies

4.44 Organizations outside the governmental entity being audited may also have an effect on internal control. For example, federal or state programs may provide a significant portion of a local government's revenues. The terms of the grant or entitlement agreements frequently impose considerable control requirements on the recipient. Grant provisions may relate not only to how funds are used, but also to accounting, reporting, and internal control.

4.45 Grantor agencies naturally are concerned with the quality of internal control established by grantees to assure compliance with grant terms and conditions. The independent auditors are also concerned because the scope of the audit may be affected by the adequacy of the existing internal control. Failure to comply with the terms of grant agreements may give rise to contingent liabilities for the return of revenues, which may have a material impact on the financial statements. Thus, noncompliance becomes a factor in the auditor's ability to express an opinion on the financial statements of the grantee.

Internal Auditors

4.46 As in commercial enterprises, the internal auditors of governmental entities usually play a significant role in monitoring internal control and making recommendations for improvement. The internal audit organization usually attempts to maintain its independence from the executive, legislative, or judicial branches, although, administratively, it may report to any one of them.

4.47 The executive branches of state and federal governments frequently establish internal audit organizations within each operating department. Such a departmental internal audit organization is normally responsible for (a) the internal audit of departmental activity, and (b) the audit of grantees (beneficiaries) to whom the department provides funds in accordance with legislative programs.

4.48 Auditors should recognize the variety of roles and perspectives that internal auditors may have within government and the effects on the organization's internal control. The presence of an internal audit function may affect an organization's internal control in two ways. First, an internal audit function usually increases the attention devoted to internal control. Second, to the extent an internal audit function is responsible for a continuing evaluation of internal control, it serves the important role of monitoring internal control (see also paragraphs 4.16 through 4.18). SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), discusses the effects of internal audit organizations on the independent auditor's audit. Further, *Government Auditing Standards* requires that independent public accountants, governmental auditors, and internal auditors conducting audits pursuant to such standards comply with the same continuing education and quality control standards.

Chapter 5

Testing and Reporting on Compliance With Laws and Regulations

Introduction

5.01 This chapter describes the auditor's responsibility for considering laws and regulations and how they affect the financial statement audit. The auditor's responsibility for compliance auditing related to federal awards is discussed in SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (see appendix M).

5.02 Governmental entities, because they are established by and operate under numerous laws and regulations, are generally subject to many more legal constraints than are their nongovernmental counterparts. GASB Cod. sec. 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.

5.03 Because of the variety of audit requirements to which entities receiving governmental financial assistance are subject, paragraph 21 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801.21) states that 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 should consider including a statement about the type of engagement and whether it is intended to meet specific audit requirements. See also paragraph 3.02 regarding establishing an understanding with a client.

5.04 The management of the entity is responsible for ensuring compliance with the laws and regulations applicable to its activities. That responsibility encompasses identifying applicable laws and regulations and establishing internal control designed to provide reasonable assurance that the entity complies with those laws and regulations. The auditor's responsibility for testing and reporting on compliance with laws and regulations varies according to the terms of the engagement (paragraph 5 of SAS No. 74 [AICPA, *Professional Standards*, vol. 1, AU sec. 801.05]).

5.05 Management is also responsible for obtaining audits that satisfy relevant legal, regulatory, or contractual requirements. Paragraph 22 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.22) states that GAAS do not require the auditor to perform procedures beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. However, if during a GAAS

audit of the financial statements, the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.⁸ For example, the auditor will be required to make this communication if he or she is engaged to perform an audit of an entity's financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement, the entity also is required to have an audit performed in accordance with one or more of the following:

- *Government Auditing Standards*, issued by the Comptroller General of the United States
- The Single Audit Act Amendments of 1996 and OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*
- Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

5.06 Paragraph 23 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.23) states that the required communication 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 their potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317).

5.07 In the following paragraphs, the requirements of GAAS that are applicable to the auditor's consideration of compliance in a financial statement audit are summarized and the additional requirements of *Government Auditing Standards* are discussed.

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

General Guidance

5.08 SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801) provides general guidance when the auditor is engaged to test and report on compliance with laws and regulations under GAAS, *Government Auditing Standards*, and OMB Circular A-133. SAS No. 74 describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit and also discusses the auditor's responsibility for compliance auditing related to federal awards in an audit performed under Circular A-133.

⁸ For 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.

5.09 The auditor is required to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations, error, or fraud. SAS No. 54 describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 312), describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors. The requirements of SAS Nos. 54, 82, and 47 are described in paragraphs 5.10 through 5.29.

SAS No. 54 Requirements

5.10 SAS No. 54 requires the auditor to 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.^{9, 10} This involves identifying laws and regulations that may have a direct and material effect on the determination of financial statement amounts, and then assessing the risk that noncompliance with these laws and regulations may cause the financial statements to contain a material misstatement. The auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se.

5.11 Although it has not been explicitly stated in SAS No. 54, the phrase "laws and regulations" has generally been interpreted to implicitly include the provisions of contract and grant agreements (see paragraphs 5.32 and 5.33). Laws, regulations, and provisions of contracts and grant agreements are referred to in this guide as "compliance requirements." Violations of laws, regulations, and provisions of contracts and grant agreements are referred to in this guide as "instances of noncompliance."

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

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

5.13 The auditor may consider performing the following procedures in assessing management's identification of these compliance requirements and

⁹ Paragraph 3.12 of this guide states that, for general-purpose financial statements, "audit scope should be set and materiality evaluations should be applied at the fund type, account group, and discretely presented component unit column(s) when reporting on the GPFS..."

¹⁰ The auditor undertakes the same responsibility in an audit of financial statements conducted in accordance with *Government Auditing Standards*. See paragraphs 5.32 and 5.33 for further discussion.

in obtaining an understanding of their possible effects on the determination of financial statement amounts:

- a. Consider knowledge about these compliance requirements that has been obtained from prior years' audits.
- b. Discuss these compliance requirements with the entity's chief financial officer, legal counsel, or grant administrators.
- c. Obtain written representation from management regarding the completeness of management's identification of compliance requirements (see paragraph 5.31).
- d. Review the relevant portions of any directly related agreements, such as those related to grants and loans.
- e. Identify sources of revenue, review any related agreements (for example, loan agreements or grant agreements) and inquire about the applicability of any overall governmental regulations to the accounting for the revenue.
- f. Obtain publications pertaining to compliance requirements. These publications often address federal tax and other reporting requirements, such as the Department of the Treasury and the Internal Revenue Service requirements pertaining to information returns and regulations concerning the calculation of arbitrage rebates and refunds.
- g. Obtain copies of, and review pertinent sections of, the state constitution, laws, and regulations concerning the entity. The sections of these documents pertaining to financial reporting, debt, taxation, budget, and appropriation and procurement matters may be especially relevant.
- h. Review the minutes of meetings of the governing body of the entity for the enactment of laws and regulations or information about contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- i. Inquire of the office of the federal, state, or local auditor or other appropriate audit oversight organization about the compliance requirements applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.
- j. Review information about applicable federal and state program compliance requirements, such as the information included in the *Compliance Supplement*, the CFDA, and state and local policies and procedures.
- k. Review the accounting and auditing guidance applicable to specific industries as found in this guide and other AICPA Audit and Accounting Guides (such as *Not-for-Profit Organizations*, *Health Care Organizations*, and *Audits of Colleges and Universities*^{*}) and review the materials available from other professional organizations, such as state societies of CPAs or industry associations.

^{*} Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

- l.* Inquire of the audit, finance, or program administrators from which grants are received about the restrictions, limitations, terms, and conditions under which such grants were provided. These administrators can usually be helpful in identifying compliance requirements, which they may identify separately or publish in an audit guide.¹¹

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

- The materiality of the effect on financial statement amounts.
- The level of management or employee involvement in the compliance-assurance process.
- The opportunity for concealment of instances of noncompliance.

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

5.16 Governmental entities may be affected by many other laws and regulations, including those related to occupational safety and health, environmental protection, equal employment, food and drug, and price fixing. These laws and regulations generally concern an entity's operations more than financial reporting and accounting. Their effect on an entity's financial statements is indirect and normally takes the form of the disclosure of a contingent liability that follows from the allegation or determination of illegality. The auditor would not ordinarily have sufficient basis to recognize possible violations of these laws and regulations. Even when violations of such laws and regulations can have consequences that are material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he or she is informed by the entity, or unless there is evidence of an investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.¹²

5.17 If specific information comes to the auditor's attention that provides evidence concerning the existence of possible instances of noncompliance that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an instance of noncompliance occurred. However, because of the characteristics of

¹¹ In assessing management's identification of requirements governing federal awards and obtaining an understanding of their possible effects on the determination of financial statement amounts, the auditor may use as a reference source the *OMB Circular A-133 Compliance Supplement*. See SOP 98-3 in appendix M for further information on the *Compliance Supplement*.

¹² In 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 (a) the client's policies relative to the prevention of illegal acts and (b) the use of directives issued by the client, as well as periodic representations obtained by the client, from management at appropriate levels of authority, concerning compliance with laws and regulations.

such noncompliance, an audit made in accordance with GAAS provides no assurance that indirect-effect instances of noncompliance will be detected or that any contingent liabilities that may result will be disclosed.

5.18 *Examples of the Effects of Certain Laws and Regulations on a Governmental Entity's Financial Statements.* Some states have adopted rules governing the performance of compliance audits that clearly define the auditing and reporting expectations for audits of local governmental units.

5.19 The adoption of specific compliance auditing requirements by state and local jurisdictions makes it imperative that auditors assess whether management has identified the specific compliance matters, as well as the related criteria for determining compliance, to be addressed within the scope of those audits.

5.20 The following are examples 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. Such laws and regulations may be relevant to an entity whether or not it is legally required to prepare financial statements in accordance with GAAP.

- a. *Reporting Entity.* For those entities required by law or regulation to prepare financial statements in accordance with GAAP, GASB Cod. sec. 2100 establishes criteria for determining the organizations, functions, and activities of government that should be included in the financial reporting entity. The financial reporting entity consists of the primary government, the organizations for which the primary government is financially accountable, and other organizations that, if not included, would cause the reporting entity's financial statements to be misleading or incomplete. In defining the financial reporting entity, management should consider applicable laws and regulations.
- b. *Tax Reporting.* Report in accordance with federal and state requirements.
- c. *Procurement.* Contract or make procurement through competitive bidding or negotiation.
- d. *Appropriations.* Expend resources within authorized limits.
- e. *Legal Authority for Transactions.* Execute transactions with proper legal authority.
- f. *Establishment of Funds.* GASB Cod. sec. 1300.105 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 statute may require that proceeds of a state gasoline tax be accounted for in a special revenue fund.

- g. *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. GASB Cod. sec. 2400 requires that the GPFS present an aggregation by governmental

fund type of the annual appropriated budgets, as amended, compared to actual results of operations.

- h. *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. GASB Cod. sec. G60.111 states that if such matching requirements exist, revenue recognition depends on compliance with those requirements.*
- i. *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 the proceeds of a state gasoline tax be expended only for the 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 the establishment of a special revenue fund. GASB Cod. sec. 1300.107 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.”
- j. *Taxing and Debt Limitations.* Certain governmental entities may be subject to laws and regulations that limit local government taxing authority, impose ceilings and other issuance criteria on debt, or limit the use of debt proceeds.
- k. *Types of Compliance Requirements.* Certain types of compliance requirements identified in the OMB’s Compliance Supplement may have a direct and material effect on the determination of financial statement amounts in some circumstances. For example, certain costs not allowable by federal programs may have been inappropriately allocated to federal programs as indirect costs. 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 type of compliance requirement, and could have a direct and material effect on the determination of cost-related amounts in the entity’s financial statements.

5.21 For these and other compliance matters within the scope of the audit, the auditor should seek guidance from affected local officials, state officials with oversight responsibility, and appropriate legal counsel.

5.22 The GASB Codification also includes requirements to disclose violations of certain laws and regulations. GASB Cod. sec. 2300.106 states:

Notes to the financial statements essential to fair presentation at the GPFS [general-purpose financial statements] level include . . . [h.] Material violations of finance-related legal and contractual provisions.

* GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, establishes accounting and financial reporting standards for nonexchange transactions involving financial or capital resources (for example, most taxes, grants, and private donations). The principal issue addressed in GASB Statement No. 33 is the timing of recognition of nonexchange transactions. It is effective for financial statements for periods beginning after June 15, 2000, with earlier application encouraged. References to the recording of transactions addressed by GASB Statement No. 33 will be modified to conform to the requirements of GASB Statement No. 33 in a future edition of this guide. Paragraphs 8.17 through 8.24 provide a summary adapted from GASB Statement No. 33.

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.

5.23 GASB Cod. sec. I50.122 to I50.123 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 is based on the disclosure requirements specified by GAAP.

SAS No. 82 Requirements

5.24 SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110), states that the auditor also has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. SAS No. 82 provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.

5.25 Although fraud is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of financial statements is intentional or unintentional. Two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets. These two types of misstatements, as well as the characteristics of fraud, are discussed further in paragraphs 3 through 10 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.03–10).

5.26 The risk of material misstatement of the financial statements due to fraud is part of audit risk. Therefore, the auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets in each of the following categories:

Misstatements Arising From Fraudulent Financial Reporting

- Management's characteristics and influence over the control environment
- Industry conditions
- Operating characteristics and financial stability

Misstatements Arising From the Misappropriation of Assets

- Susceptibility of assets to misappropriation
- Controls

The auditor should exercise professional judgment when considering (a) risk factors individually or in combination and (b) whether there are specific controls that mitigate the risk. Risk factors are discussed in greater detail in paragraphs 16 through 25 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.16–25). Auditors may wish to refer to the AICPA practice aid

titled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which includes specific nonauthoritative guidance on applying the concepts of SAS No. 82 to several industries, including government, health care, and not-for-profit organizations.

5.27 In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud. Where risk factors are identified as being present, the documentation should include (a) those risk factors identified and (b) the auditor's response to those risk factors, individually or in combination. In addition, if, during the performance of the audit, fraud risk factors or other conditions are identified that cause the auditor to believe that an additional response is required, these risk factors or other conditions, as well as any further response that the auditor concluded was appropriate, should also be documented.

5.28 SAS No. 82 also contains requirements on the auditor's response to the results of the assessment of risk, the evaluation of audit test results, and communications about fraud to management, the audit committee, and others. Auditors should refer to SAS No. 82 for a description of the specific requirements in those areas (see also paragraphs 10.18 through 10.20).

SAS No. 47 Requirements

5.29 SAS No. 47, as amended by SAS No. 82, provides guidance to auditors in fulfilling the responsibility described in paragraph 5.24, as it relates to errors, in an audit of financial statements conducted in accordance with GAAS. Errors are described as unintentional misstatements, or as omissions of amounts or disclosures, in financial statements. Errors may involve (a) mistakes in gathering or processing data from which financial statements are prepared, (b) unreasonable accounting estimates arising from oversight or the misinterpretation of facts, and (c) mistakes in the application of accounting principles relating to amounts, classification, the manner of presentation, or disclosure. When the auditor is considering his or her responsibility to obtain reasonable assurance that the financial statements are free of material misstatement, there is no important distinction between error and fraud. There is a distinction, however, in the auditor's response to detected misstatements. An isolated, immaterial error in processing accounting data or in applying accounting principles is generally not significant to the audit. In contrast, when fraud is detected, the auditor should consider its implications for the integrity of management or employees and its possible effect on other aspects of the audit. Auditors should refer to SAS No. 47 for more detailed guidance.

Working Paper Documentation

5.30 The auditor should document the 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*.¹³ (See paragraphs 3.34 and 3.35 for a discussion of the *Government Auditing Standards* requirements related to working papers.) The

¹³ The Audit Issues Task Force of the Auditing Standards Board has issued an interpretation of SAS No. 41 titled, "Providing Access to or Photocopies of Working Papers to a Regulator." The complete text of the interpretation was published in the July 1994 issue of the *Journal of Accountancy* and is also included in appendix K, herein.

fraud risk factors identified and the auditor's response to those risk factors should be documented in accordance with SAS No. 82 (see paragraph 5.27). The auditor's understanding of internal control over financial reporting 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, as amended by SAS No. 78 (see paragraph 4.24).

Written Representations From Management

5.31 SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), requires the auditor to obtain written representations from management as part of an audit conducted in accordance with GAAS. It also includes an illustrative management representation letter and an appendix containing additional representations that may be appropriate to be included in a management representation letter in certain circumstances. With respect to compliance requirements affecting the financial statement audit, auditors should consider obtaining additional representations from management acknowledging that management—

- a. Is responsible for compliance with the laws, regulations, and provisions of contracts and grant agreements applicable to the entity.
- b. Is responsible for establishing and maintaining effective internal control over financial reporting.
- c. Has identified and disclosed to the auditor all laws, regulations, and provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- d. Has identified and disclosed to the auditor violations (or possible violations) of laws, regulations, and provisions of contracts and grant agreements whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

Fieldwork Responsibilities Under Government Auditing Standards

5.32 *Government Auditing Standards* prescribes additional field work standards beyond those required in an audit in accordance with GAAS on audit follow-up and working papers. See paragraphs 3.34 and 3.35 for further discussion of working paper requirements and paragraph 3.36 for further discussion of audit follow-up. Although *Government Auditing Standards* refers to the auditor's responsibilities with regard to noncompliance with provisions of contracts or grant agreements as an *additional* field work standard, auditors have this same responsibility under GAAS. See further discussion below and also paragraph 5.11.

5.33 Noncompliance includes not only illegal acts, but also violations of provisions of contracts or grant agreements. Both *Government Auditing Standards* and GAAS require auditors to design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of laws, regulations, contracts, and grant agreements that have a direct and material effect on the determination of financial statement amounts. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible noncompliance with provisions of

laws, regulations, contracts, or grant agreements that could have a material indirect effect on the financial statements, auditors should apply procedures specifically directed to ascertaining whether that noncompliance has occurred. When the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that noncompliance has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.

Reporting

5.34 *Government Auditing Standards* prescribes as part of the financial statement audit additional reporting requirements beyond those in GAAS that are related to compliance. With regard to reporting, *Government Auditing Standards* requires, among other things, that the auditor report on the scope of his or her testing of compliance and present the results of those tests. See the following paragraphs and paragraphs 18.57 through 18.62 for a more detailed discussion of the *Government Auditing Standards* reporting requirements related to compliance and for a listing of the basic elements that should be included in the report.^[14]

5.35 The auditor's report on compliance is based on the results of procedures performed as part of the audit of financial statements. Matters the auditor considers in reporting on compliance in accordance with *Government Auditing Standards* are as follows:

- a. Description of the scope of the auditor's testing of compliance (paragraph 18.59)
- b. Reporting fraud and illegal acts (paragraphs 5.36 and 5.39)
- c. Reporting noncompliance (paragraphs 5.40 through 5.46)

5.36 *Reporting Fraud and Illegal Acts.* *Government Auditing Standards* requires that when auditors conclude, based on evidence obtained, that fraud or an illegal act either has occurred, or is likely to have occurred, they should report relevant information. Auditors need not report information about fraud or an illegal act that is clearly inconsequential. Thus, auditors should present in a report the same fraud and illegal acts that they report to audit committees under GAAS.

5.37 *Direct Reporting of Fraud and Illegal Acts.* Paragraphs 5.21 through 5.25 of *Government Auditing Standards* provide guidance on the direct reporting of fraud and illegal acts. *Government Auditing Standards* requires that in addition to any legal requirements for the direct reporting of fraud or illegal acts, auditors must report fraud or illegal acts directly to parties outside the entity in the following two circumstances (auditors should meet these requirements even if they have resigned or been dismissed from the audit):

- a. The entity may be required by law or regulation to report certain fraud or illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general). If auditors have communicated such fraud or illegal acts to the entity, and it fails to report them, then auditors should communicate their awareness of that failure to the entity's governing body. If the entity does

^[14] [Deleted.]

not make the required report as soon as practicable after the auditors' communication with its governing body, then the auditors should report the fraud or illegal acts directly to the external party specified in the law or regulation.

- b. When fraud or an illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statement or resign from the audit, then they should communicate that conclusion to the entity's governing body. Then, if the governmental entity does not report the fraud or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the fraud or illegal act directly to that entity.

5.38 In both of these situations, auditors should obtain sufficient, competent, and relevant evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported fraud or illegal acts. If they are unable to do so, the auditors should report the fraud or illegal acts directly, as discussed previously.

5.39 Paragraph 4.16 of *Government Auditing Standards* reminds auditors that under some circumstances, laws, regulations, or policies may require them to report indications of certain types of fraud or illegal acts promptly to law enforcement or investigatory authorities. When auditors conclude that this type of fraud or illegal act either has occurred or is likely to have occurred, they should ask those authorities, legal counsel, or both, if reporting certain information about that fraud or illegal act would compromise investigative or legal proceedings. Auditors should limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

5.40 *Reporting Noncompliance.* Material instances of noncompliance are 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 his or her report on compliance to report relevant information. The report should include—

- a. An identification of material instances of noncompliance noted.¹⁵
- b. 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 GAAP.

5.41 The auditor should report material instances of noncompliance regardless of whether the resulting misstatements have been corrected in the en-

¹⁵ Paragraph 5.19 of *Government Auditing Standards* provides the following guidance on reporting fraud, illegal acts, or other noncompliance: "... auditors should place their findings in proper perspective. To give the reader a basis for judging the prevalence and consequences of these conditions, the instances identified should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate. In presenting fraud, illegal acts, or other noncompliance, auditors should follow chapter 7's [of *Government Auditing Standards*] report contents standards for objectives, scope and methodology; audit results; views of responsible officials; and its report presentation standards, as appropriate."

tity'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. An illustration of the auditor's report on compliance when there are material instances of noncompliance are presented in example A.16(A) of appendix A.

5.42 Paragraph 5.20 of *Government Auditing Standards* includes the following provisions for reporting on fraud, illegal acts, or other noncompliance (see paragraphs 5.36 through 5.39 for further reporting guidance on fraud and illegal acts):

When auditors detect fraud, illegal acts, or other noncompliance that do not meet paragraph 5.18's [of *Government Auditing Standards*] criteria for reporting, they should communicate those findings to the auditee, preferably in writing. If auditors have communicated those findings in a management letter to top management, they should refer to that management letter when they report on compliance. Auditors should document in their working papers all communications to the auditee about fraud, illegal acts, and other noncompliance.

5.43 If the auditor has issued a separate letter describing immaterial instances of noncompliance, the report on compliance prepared in accordance with the preceding paragraphs should be modified to include a statement such as the following: "We noted certain immaterial instances of noncompliance which we have reported to management of [name of entity] in a separate letter dated August 15, 19X1."

5.44 For audits in accordance with GAAS and *Government Auditing Standards*, the effects of any material violations or possible violations of laws or regulations identified as a result of the auditor's procedures should be considered for disclosure in the footnotes to the financial statements or as a basis for recording a loss contingency, as provided for in FASB Statement No. 5, *Accounting for Contingencies*. If disclosure is not made or a loss is not recorded, the auditor should consider modifying the audit report on the financial statements, for example, by giving a qualified opinion using "except for" wording. See SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), for guidance. The auditor's consideration of illegal acts is discussed further in paragraphs 5.10 through 5.23, 5.32, and 5.33.

5.45 When the auditor cannot examine evidence sufficient to determine whether compliance with applicable laws and regulations exists, and if the potential effect of noncompliance could be material, a scope limitation may exist and the auditor's report on the financial statements would be modified accordingly.

5.46 There may be situations where the auditor has determined that the entity did not comply with an applicable law or regulation, but management is unable to make a reasonable estimate of the financial effect expected to result from the noncompliance. *Government Auditing Standards* requires a compliance report to be issued regardless of whether the financial effect of the noncompliance is fully known, and, accordingly, the standard report, as illustrated in example A.16 in appendix A, would be modified to reflect the results of the audit procedures (see example A.16(A) in appendix A for an illustration). The auditor should also consider the effect of the noncompliance on the general-purpose financial statements and modify the report on those statements as necessary in accordance with SAS No. 58, as amended by SAS No. 79.

Reasonable Assurance

5.47 SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), states that since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her audit report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with GAAS.

Part II
The State and Local Government Audit—
Governmental Funds and Account Groups

Chapter 6

The Budget

Introduction

6.01 Budgeting is an essential element of the financial planning, control, and evaluation processes of governments. Almost all states currently require political subdivisions to adopt budgets for at least their general fund. Many states also require budgets to be adopted and reported for special revenue and debt service funds and, sometimes, for other funds of governmental units. The budgeting practices followed by governmental units vary greatly, and the auditor should be knowledgeable about the laws and regulations governing the budgetary requirements of the governmental unit being audited.

6.02 GASB Cod. secs. 1700 and 2400 discuss the budget, budgetary accounting, and budgetary reporting. The basic statement of principle included in the Codification regarding budgeting and budgetary control asserts that—

- a. An annual budget(s) should be adopted by every governmental unit.
- b. The accounting system should provide the basis for appropriate budgetary control.
- c. A common terminology and classification should be used consistently throughout the budget, the accounts, and the financial reports of each fund.

6.03 In certain circumstances, a budget is not adopted because it is not legally required and, therefore, comparative budget and actual results cannot be presented. That situation should be disclosed in a note to the financial statements and the otherwise required financial statement omitted. The auditor's report on the financial statements is not affected. However, if a budget is legally adopted but budget and actual results are not presented, the auditor should express a qualified or adverse opinion because of a departure from GAAP. When adoption of a budget is legally required, presentation of budget and actual results is required by GAAP. Failure to present both budget and actual results in such circumstances is a departure from GAAP. Failure to adopt a budget when adoption of a budget is legally required is an illegal act. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), states that if the auditor concludes that an illegal act has a material effect on the financial statements, and the act has not been properly accounted for or disclosed, the auditor should express a qualified opinion or an adverse opinion on the financial statements taken as a whole, depending on the materiality of the effect on the financial statements.

6.04 When conducting an audit of a state or local governmental unit, the auditor's understanding of the budget and the budgetary process is important. GASB Cod. sec. 2400 states that "Budgetary comparisons should be included in the appropriate financial statements and schedules for governmental funds for which an annual budget has been adopted." Thus, the auditor needs to understand the budget and the budget process in order to evaluate the appropriateness of budget information that is presented in the financial statements. When GAAP requires the presentation of budget information in the financial statements, the failure of a governmental unit to present appropriate budgets

may lead to inadequate financial statement disclosures that would require the auditor to modify his or her report on the financial statements. Knowledge of the budget process may also serve as a useful tool when performing analytical procedures during a governmental engagement. See paragraphs 6.26 through 6.28 for further information.

Types of Budgets

6.05 Governmental units may establish many different types of budgets, which may not be mutually exclusive. When one thinks of the term *budget*, one usually envisions a document developed to control revenues and expenditures for an operating period of one year. Expenditures may be controlled at the program, department, character, or object level of expenditure, as discussed later in this chapter. However, governmental units may develop a number of other budgets for various purposes and periods. Budgets also may be developed to measure service rather than monetary levels. Following are examples of other budgets that may be prepared by governmental units.

Capital Budgets

6.06 Capital budgets usually present estimates of revenues and expenditures for a period of several years—usually four to six—and the proposed means of financing capital outlays. They are planning documents that typically emphasize major program or capital outlay plans. Capital budgets should be updated periodically as priorities change and/or unanticipated projects come up. In conjunction with the preparation of capital budgets and the related sources of financing, the governmental unit also can anticipate future changes in allowable debt levels and annual debt service requirements.

Proprietary Fund Flexible Budgets

6.07 The nature of most operations financed and accounted for through proprietary funds is such that the demand for the goods and services provided largely determines the appropriate level of revenues and expenses. Increased demand for the goods or services causes a higher level of expense to be incurred, but also results in a higher level of revenues. Thus, as in commercial accounting, flexible budgets—prepared for several levels of possible activity—typically are better for proprietary fund planning, control, and evaluation purposes than are fixed budgets. Ideally, the basis on which the budget is prepared should be consistent with the basis of accounting used.

6.08 When formally adopted, the expense estimates of flexible budgets typically are not viewed as appropriations but as approved plans. Budgetary control and evaluation are effected by comparing actual interim or annual revenues and expenses with planned revenues and expenses at the actual level of activity for the period. In some instances, local legal requirements may require a budget to be adopted for proprietary funds.

Performance Budgets

6.09 Performance budgets cover programs but they emphasize output, units of work performed, or services rendered within each program, such as tons of waste collected in the rubbish disposal program. Performance budgets relate the input of resources to the output of services.

Budgetary Comparisons Included in Financial Statements

6.10 A combined statement of revenues, expenditures, and changes in fund balances—budget and actual, general and special revenue fund types (and similar governmental fund types of the primary government for which annual budgets have been legally adopted)—is required to be presented as part of the GPFS, GASB Cod. sec. 2400.102.

6.11 The minimum budget-basis presentation within the GPFS of a reporting entity is the aggregation by governmental fund type of the annual appropriated budgets for those funds, as amended, compared with related actual amounts. The annual appropriated budgets are those adopted by either the legislative or governing board of the primary government (and its component units that have been blended and are, as a result, reported with the primary government). Budgetary data for discretely presented component units are not required to be presented in the reporting entity's combined statement of revenues, expenditures, and changes in fund balance—budget and actual. (See GASB Cod. sec. 2400.103.)

Auditor's Responsibility for Budgetary Information

6.12 The basis on which a budget is prepared frequently is determined by state or local statutes, charters, or ordinances. When the budget has been prepared on a basis other than GAAP (for example, on a cash basis), the actual results reported on a GAAP basis should be restated to the same basis used in preparing the budget when preparing the actual and budget statement. The financial statements, or notes thereto, are required to provide a reconciliation of the actual results reported on a GAAP basis to the results reported on a budgetary basis.

6.13 Many governmental units approve amendments to the original budget during the year. The comparison of actual results to budgeted results included in the GPFS should include all approved budget amendments in the budgeted numbers reported.

6.14 Auditing standards do not provide for any difference in the level of audit assurance on the budgeted results reported versus the actual results reported. The auditor's procedures related to the budgetary information presented may be limited to determining the following:

- Which methods were used to assemble the original budget.
- That amendments were properly approved during the year.
- That the budget reflects all approved amendments.
- That applicable state and local statutes have been followed when adopting the budget and in approving subsequent amendments.

Budgetary Compliance With Laws and Regulations

6.15 SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), provides that 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 the financial statements in all audits of governmental units conducted in accordance with GAAS. A legally adopted budget—which may take many forms, ranging from a single document that identifies all revenue sources and expenditures to num-

erous revenue and appropriation bills or ordinances—is the legal authority for the levy of taxes and the expenditure of monies. The auditor performs procedures to obtain an understanding of the laws governing the budgetary process and to determine whether budgets have been prepared and adopted in compliance with applicable laws and regulations. Those procedures may include, but are not limited to—

- Discussing with management and/or legal counsel the applicable statutes and ordinances governing the legal status of the budget and its applicability to the various funds of the governmental unit.
- Determining the level of budgetary control—that is, object, department, program, or fund, and the adequacy of the accounting system to operate at that level of control.
- Determining the basis of accounting on which the budget is prepared.
- Considering whether the budgetary process was performed in accordance with statutes and ordinances, including required public notifications and hearings.
- Reviewing the adopted budget for proper approval.
- Considering whether changes to the budget during the audit period were approved in accordance with applicable local and state laws.
- Evaluating whether material expenditures over appropriations in individual funds are disclosed.

Level of Budgetary Control

6.16 The auditor evaluates the effect on the financial statements (that is, the need for additional financial statement disclosures) of noncompliance with laws and regulations governing expenditures in excess of budgetary appropriations based on the legal level at which budgetary control is exercised. As stated in GASB Cod. sec. 2300.106, any excess of expenditures over appropriations in individual funds is to be disclosed in the notes to the GPFS. Budgetary control is commonly exercised at one of the following levels within the fund.

6.17 *Program Function Level.* A program budget emphasizes the cost of specific programs of governmental services without regard to the number of departments or divisions that may be involved in providing the services. Objectives are established for each program and costs to accomplish the objectives are estimated. The advantage of a program budget is that it considers the aggregate cost of individual programs. A disadvantage is that it is sometimes difficult to impose accountability on individual departments, divisions, or agencies.

6.18 *Organizational Unit or Departmental Level.* Budgeting by departmental unit promotes responsibility accounting. This classification corresponds with the governmental unit's organization structure. A particular department may be charged with carrying out one or several activities or programs.

6.19 *Character Level.* In addition to program or departmental budgets, expenditures may be further classified by character, that is, on the basis of the fiscal period they are presumed to benefit. The major character classifications of expenditures are *current expenditures*, which benefit the current fiscal period; *capital outlays*, which are presumed to benefit both the present and future fiscal periods; and *debt service*, which is presumed to benefit prior fiscal periods as well as current and future periods. *Intergovernmental*, a fourth

character classification, is appropriate where one governmental unit transfers resources to another, such as when states transfer *shared revenues* to local governments or act as intermediaries in federally financed programs. (See GASB Cod. sec. 1800.120.)

6.20 *Object Level.* Expenditures may be classified by object classes, that is, according to the types of items purchased or services obtained. Examples of *current operating* objects of expenditure classifications are personal services, supplies, and other services and charges. *Capital outlays*, *intergovernmental*, and *debt service* also are major objects-of-expenditure classifications.

6.21 In most governmental organizations, compliance with legal budgetary requirements is usually monitored at either the program or department level, although other levels may be used in some governmental units. The governmental unit also may monitor expenditures at the character or object level, but this is done usually for managing expenditures rather than as a legal requirement. For example, a governmental unit may monitor expenditures for a given department at the departmental level. The fact that salary costs of that department may exceed budget, but that outside services are less than budget, may be useful for management purposes. However, as long as that department's expenditures, in total, are less than the budgeted level, noncompliance with legal budgetary laws and regulations may not exist. In instances where the governmental unit was legally required to monitor expenditures at the object level, a given department's salaries exceeding the budget may represent noncompliance with budgetary laws and regulations even though the department, in total, spent less than the amount budgeted.

Encumbrances

6.22 A final component of budgetary accounting, which is characteristic of governmental units, is encumbrance accounting, especially in general and special revenue funds. Encumbrances represent formal commitments (usually contracts or purchase orders) to acquire goods or services not yet received. They may be recorded in the accounts to ensure that expenditures do not exceed appropriations. Encumbrances outstanding at year end do not represent expenditures in accordance with GAAP. However, they may represent a portion of the fund balance that should be reserved for commitments made during the year.

6.23 Some state laws may require encumbrances outstanding at year end to be considered as expenditures to be charged against current year appropriations. In these cases, encumbrances will be included with the expenditures reported on the budget and actual comparison statements. Outstanding encumbrances at the beginning and end of the year would be used to reconcile expenditures reported on the combined statement of revenues and expenditures with expenditures reported on the budget and actual budgetary-basis financial statement. The method by which encumbrances are accounted for and reported should be consistently applied and disclosed in the summary of significant accounting policies. (See GASB Cod. sec. 1700.130.)

Audit Considerations

6.24 The auditor's understanding of a governmental unit's practices in developing a budget and controlling operations through the budget may be a

significant component of the auditor's understanding of the control environment of a governmental unit.

6.25 In documenting the understanding of the controls a governmental unit uses to develop and implement the budget, the auditor considers controls that may be in place to ensure that expenditures have been properly approved, monitored, and classified within the accounts. If the auditor determines that these controls have been placed in service and are functioning properly, the auditor may assess control risk at less than the maximum and use the budget as a basis for reducing some substantive tests that otherwise may be necessary.

6.26 Under SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), the auditor performs analytical procedures in both the planning and overall review phases of all audit engagements. An analytical procedure that compares actual results to budgeted results may be useful during the planning phase of the audit. However, the auditor must consider the effectiveness of the client's approach to budgeting and its philosophy regarding amendments to the budget, as well as the effectiveness of the client's controls over proper recording and classification of expenditures.

6.27 Some governments adopt a budget after a thorough and thoughtful process and then use it to control operations. Other governments adopt a preliminary budget and amend it frequently, essentially allowing the budget to follow the results of operations. In the latter situation, comparing actual results to either the original or amended budgets may not be very useful. And, whether subsequently amended or not, if the original budget was not intended to be an operating guide, comparing actual results to the original budget may not be useful.

6.28 On the other hand, when amending the budget, management of the governmental unit already may have investigated adequately and approved the variances of current results compared with the original budget. Therefore, the auditor may conclude that no further investigation is needed and that comparisons of actual results against amended budgeted results may identify adequately variances otherwise requiring additional investigation by the auditor.

Management Representations

6.29 As part of obtaining representations from management at the conclusion of the audit, the auditor may want to obtain specific representations, such as the following, about the budgetary process from management in the management representation letter.

- Applicable laws and regulations have been followed in adopting the budget.
- Approved budget amendments have been incorporated into the budget information included in the financial statements.
- Applicable laws and regulations have been followed in approving amendments to the original budget.

6.30 Even though the auditor's responsibilities for the budget information included in the GPFs are limited to those described above, the auditor may become aware, during the course of the audit, of inappropriate budgeting techniques or estimates. With declining federal and state support of local government operations, declining tax bases, and other economic factors, governmental units sometimes utilize unique budgetary practices that may be in-

appropriate or unachievable. Even though not required by professional standards (unless the techniques or estimates represent errors, irregularities, or illegal acts), the auditor may want to communicate his or her findings or concerns to appropriate levels of management within the governmental entity.

Chapter 7

Cash and Investments

Introduction

7.01 Although the cash and investment transactions of governmental units are similar to those of business enterprises, they differ in several significant ways. These differences include the nature of transactions, accounting and compliance, financial statement presentation and disclosure, internal control and auditing considerations.

7.02 GASB Cod. secs. C20, D25, I50, I55, I60, In5, Pe5, Pe6, Po20, 2300.601, and 2450 provide guidance on the accounting and financial statement presentation and disclosure requirements for cash and investment transactions. Additional guidance is provided in the following GASB staff documents:

- *Questions and Answers Guide to Implementation of GASB Statement No. 3 on Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*
- *Questions and Answers Guide to Implementation of GASB Statement No. 31 on Accounting and Financial Reporting for Certain Investments and for External Investment Pools*
- *Questions and Answers Guide to Implementation of GASB Statements 25, 26, and 27 on Pension Reporting and Disclosure by State and Local Government Plans and Employers*

Nature of Transactions

Decentralization

7.03 Cash is collected by governments to support a variety of functions and is often collected at a number of locations, such as tax collection departments for income, sales, or property taxes; billing departments for services rendered; courts for fines or judgments; and recreational facilities for user fees. In some cases, the decentralization of cash collections results when elected tax collectors function entirely separately from other finance or organizational departments of the governmental unit. Collections generally include many small receipts, as well. Because all cash collections may not be under the direct control of a centralized treasury, internal control procedures related to receiving, depositing, and recording cash may increase control risk.

Check Truncation

7.04 Because the Uniform Commercial Code (UCC S-406(I)) provides that a bank is under no obligation to return canceled checks to a customer if it makes such checks available to customers in “a reasonable manner,” many banks have developed the practice of not returning canceled checks, called check truncation. The management of a governmental unit is responsible for maintaining sufficient internal control to compensate for the absence of returned canceled checks. If state laws or agreements for intergovernmental financial assistance programs provide that the governmental unit is responsible for maintaining records that include canceled checks, the auditor should consider whether the absence of canceled checks constitutes noncompliance.

Accounting, Auditing, and Compliance Considerations

7.05 The audit of cash and investment transactions of governmental units is also affected by certain other factors, such as the pooling of cash and investments from all funds, state and local restrictions on the type of deposits or investments permitted, and the requirement for obtaining collateral and complying with arbitrage rules.

Pooling of Cash and Investments

7.06 Governmental units commonly pool both the cash and the investments of all funds for reasons of physical custody and control, enhanced investment opportunities, or operating efficiency. Pooling cash or investment activities may simplify collection, custody, and disbursement. In some cases, however, pooling cash and investments is prohibited by state or local laws or by clauses in contractual or debt-financing agreements. For example, a bond indenture may prohibit pooling the cash in a sinking fund with that of other funds.

7.07 When governmental units pool the cash accounts of several funds, each fund has an interest in the pooled account. When one fund overdraws its share of the pooled account, that fund should report an interfund liability to the fund that the management of the governmental unit deems to have loaned the cash or investments to the overdrawn fund. The fund deemed to have loaned the cash or investments should report an interfund receivable from the borrowing fund. This treatment is unaffected by whether the loaning and borrowing funds are of the same or different fund types. If the pooled cash account for the governmental unit is overdrawn in total, the balance should be classified as a fund liability.

7.08 Pooled cash accounts or investments within a governmental unit may also require an analysis of the reasonableness of management's allocation of investment earnings to the funds participating in the pool. Also, GASB Cod. sec. I50.112 states that often, income from investments associated with one fund is assigned to another fund because of legal or contractual provisions. In that situation, the accounting treatment should be based on the specific language of the legal or contractual provisions. If, however, the investment income is assigned to another fund for other than legal or contractual reasons—for example, management decision—the income should be recognized in the fund that reports the investments. The transfer of that income to the recipient fund should be reported as an operating transfer. See GASB Cod. sec. I50.112 for further details.

7.09 A governmental unit may also enter into an agreement to undertake cooperatively the investment of its money with another government or with a private entity such as a mutual fund. Many states operate investment pools for the benefit of their local governments. Such an agreement may authorize a single investment transaction or provide for the pooling and investment of idle funds on an ongoing basis. This type of agreement should include provisions for the types of investments that are permissible; the procedures for making each type of investment; whether the investments will be held in the name of a single participant or all the participants; the manner in which income, losses, and expenses will be shared; and the circumstances under which each participant may redeem or liquidate its interest therein.

State and Local Restrictions

7.10 State statutes or local ordinances usually limit the types of deposits and investments governmental units may acquire. GASB Cod. sec. I50, para-

graphs .904 through .960, addresses the nature and types of deposits with financial institutions and investments and the risks associated with them. Expenditure of cash or the use of investments may be restricted by contractual agreements or legal requirements. For example, bond proceeds may be restricted for expenditure on a specific capital project.

Repurchase and Reverse Repurchase Agreements and Securities Lending Transactions

7.11 A repurchase agreement is a hybrid transaction that has features of both a purchase and sale, and a secured loan. The characterization of a repurchase agreement as a purchase and sale is important to governments because many are prohibited from lending assets to private organizations. This prohibition may extend to lending cash and investments in the form of repurchase or reverse repurchase agreements. Often, a government will enter into a repurchase agreement providing for the purchase of specific securities matched simultaneously with an agreement to sell back those same securities to the third party at an increased price, which produces an economic gain that is accounted for as interest earnings. Other types of repurchase agreements, as well as related accounting and financial reporting guidance, are discussed further in GASB Cod. sec. I50. Governments may enter into a master repurchase agreement to clarify the intent and rights of the parties to the transaction. A reverse repurchase agreement occurs when the government has sold securities and entered into an agreement to repurchase them at some future date. This type of agreement presents both market and credit risk to the government. Auditors should refer to GASB Cod. sec. I55 for additional guidance on reverse repurchase agreements. Securities lending transactions are transactions in which governmental entities transfer their securities to broker-dealers and other entities for collateral—which may be cash, securities, or letters of credit—and simultaneously agree to return the collateral for the same securities in the future. Auditors should refer to GASB Cod. sec. I60 for additional guidance on securities lending transactions.

Collateralization

7.12 Some state statutes or local ordinances require collateralization of cash deposits by the depository institutions when they exceed the amount of any depository insurance. The purpose of designated collateral is to provide protection for deposits of the state or political subdivision. A governmental unit may require the depository institution to pledge specified types of securities as collateral equal to, for example, 100 percent to 110 percent, of the uninsured deposits. The statute or ordinance often specifies the type, ratio, or dollar amount of collateral required when the deposits exceed depository insurance. GASB Cod. secs. C20 and I50 provide a discussion on secured bank balances, collateralized or uncollateralized (see also GASB staff document, *Questions and Answers Guide to Implementation of GASB Statement No. 3*).

Arbitrage

7.13 Arbitrage earnings result when proceeds of debt issues are invested in securities paying a higher rate of interest than that which is incurred on the debt issue. As discussed in chapter 11, “Debt and Debt Service,” some governmental units issuing tax-exempt bonds are required to comply with Internal Revenue Service (IRS) arbitrage rules for rebating to the federal government excess earnings from investment of bond proceeds.

Financial Statement Presentation and Disclosure

7.14 The equity position of each fund or component unit in an internal investment pool should be reported as assets in those funds and component units. Therefore, each fund with a position in the internal investment pool should report its position as, for example, *equity in cash management pool*, *equity in internal investment pool*, *cash and cash equivalents*, or *investments*. It is sometimes necessary to classify certain cash and investments as restricted assets to comply with legal or contractual requirements (that is, revenue bond proceeds, reserve funds). In addition, the following specific GASB requirements require consideration:

- **Cash and Cash Equivalents.** On the combined balance sheet, one line is usually used to show the cash position amounts for each fund type and discretely presented component unit entities. GASB Cod. sec. 2450 requires a statement of cash flows for all proprietary and nonexpendable trust funds and component unit entities using proprietary fund accounting. Cash equivalents generally include all investments with original maturities of three months or less from the date of purchase. GASB Cod. sec. 2450.105 states that the total amounts of cash and cash equivalents at the beginning and the end of the period in the statement of cash flows should be easily traceable to similarly titled items or subtotals shown in the statements of financial position as of those dates. See GASB Cod. sec. 2450.106 for a definition of cash and cash equivalents.
- **Investments.** GASB standards require that governmental entities report many of their investments at fair value and permit or require cost-based measures for certain investments and in certain circumstances. GASB Cod. secs. I50 and In5 establish accounting and financial reporting standards for investments held by government external investment pools. GASB Cod. secs. Pe5 and Pe6 establish accounting and financial reporting standards for investments held by defined benefit and defined contribution pension plans, respectively. For other governmental entities, GASB Cod. sec. I50 establishes standards for investments in (a) interest-earning investment contracts, (b) external investment pools, (c) open-end mutual funds, (d) debt securities, and (e) equity securities, option contracts, stock warrants, and stock rights that have readily determinable fair values. Other investments in governmental funds generally are reported using cost-based measures. Cod. secs. D25 and Po20 establish additional accounting and financial reporting standards for investments held by Internal Revenue Code section 457 deferred compensation plans (see paragraph 14.14) and public entity risk pools, respectively. All investment income, including changes in the fair value of investments, is recognized in the operating statement (or other statement of activities.)
- **Disclosures for Deposits With Financial Institutions, Investments (Including Repurchase Agreements), Reverse Repurchase Agreements, and Securities Lending Transactions.** GASB Cod. secs. C20, I50, I55, I60, and In5 require certain disclosures about deposits with financial institutions, investments, reverse repurchase agreements, and securities lending transactions. Also, GASB Technical Bulletin 97-1, *Classification of Deposits and Investments into Custodial Credit Risk Categories for Certain Bank Holding Company Transactions*, clarifies the reporting of deposits and investments for certain bank holding

transactions and is effective for periods beginning after December 15, 1997, with early application encouraged. Among the required disclosures are the types of investments authorized by legal or contractual provisions, descriptions of the nature and extent of any restrictions or commitments, the methods and significant assumptions used to estimate the fair value of investments (if that fair value is based on other than quoted market prices), and the policy for determining which investments, if any, are reported using cost-based measures.

- *Derivatives and Similar Investment Transactions.* GASB Cod. sec. 2300.601 requires certain disclosures about derivatives and similar investment transactions.

7.15 For investments that are reported using cost-based measures, auditors should consider whether unrealized losses are properly recorded due to decreases in market value when the market decline is not due to a temporary condition. The liquidity needs of the governmental unit may require sales of investments at losses subsequent to the balance-sheet date. In such circumstances, auditors should consider whether this represents objective evidence of a permanent decline that should be recognized in the current financial statements. Paragraphs 31 through 33 of SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332.31–.33), include guidance for auditors when evaluating whether management has considered relevant information in determining whether an other-than-temporary impairment condition exists.

Assertions

7.16 The categories of financial statement assertions and the specific audit objectives applicable for cash and investments are related as follows:

- *Existence or Occurrence.* Cash and investments in the combined balance sheet are on hand, in transit, on deposit with third parties (depositories) in the name of the governmental unit, or are held by a third party (trust or custodian agent) on behalf of the governmental unit.
- *Completeness.* All cash and investment balances of the governmental unit are reported.
- *Rights and Obligations.* Depositories and investment counterparties are legally acceptable. If law requires depository institutions to maintain specified collateral, such collateral is adequate. Investments are of types authorized by law and the investment policy of the governmental unit.
- *Valuation or Allocation.* Cash and investment balances reflect a proper cutoff of receipts and disbursements and are reported at the proper amount. Income gains or losses are allocated to the appropriate funds.
- *Presentation and Disclosure.* Cash and cash equivalents, investments, and restricted cash and investments are reported separately by fund type. Related disclosures are adequate, and balances are fairly stated on a basis consistent with that of the preceding year.

Internal Control and Auditing Considerations

7.17 The portion of appendix B, “Illustrative Internal Control Questions—State and Local Governmental Units,” that relates to cash and investments may be considered by the auditor in performing a risk assessment.

7.18 The auditor should obtain an understanding of internal control over cash and investments. This understanding should consider the nature of all significant types of investment transactions, especially repurchase and reverse repurchase agreements, so that appropriate audit procedures may be assigned to each type of investment. The auditors should also consider the various types of risks involved, including business risk, market risk, credit risk, and risk of collateral loss, as well as the steps taken by the governmental unit to control those risks. Guidance on evaluating risks is provided in the AICPA Audit and Accounting Guide *Banks and Savings Institutions* and the AICPA's *Report of the Special Task Force on Audits of Repurchase Securities Transactions*.

7.19 Highly decentralized cash collection procedures potentially increase inherent and control risks. The auditor should consider the internal control over collection procedures at each of the various cash collection locations. Each location should have adequate segregation of duties to provide reasonable assurance of the completeness and accuracy of recorded cash transactions and balances.

7.20 Internal control should provide reasonable assurance of compliance with laws and regulations governing the collection deposit and investment of cash. Controls should exist to provide reasonable assurance of proper segregation of cash and investments and of allocations of related earnings, gains, or losses among the various funds of the governmental unit.

7.21 The auditor should consider the controls designed to prevent improper interfund borrowings, and to prevent or detect unrecorded cash receipts, especially from fines and other sources of revenue of a high volume of individual, small, cash receipts.

7.22 There are related activities, such as recreational or school activity funds, that may be part of the reporting entity under GASB Cod. sec. 2100. Cash shortages incurred through those activities may result in liabilities of the governmental unit.

Audit Procedures

7.23 In planning the audit of cash and investments, it is usually efficient and effective to apply the audit procedures for all funds of the entity, as a whole, rather than by fund type or by individual fund. These procedures include determining that the governmental unit's cash records agree with depositories' records by reviewing bank reconciliations and, in some cases, cut off bank statements obtained directly from the bank.

7.24 The cash and investment balances may be confirmed with banks or other depositories as of the balance-sheet date using the *AICPA Standard Form to Confirm Account Balance Information With Financial Institutions*. This confirmation form is limited to corroboration of information supplied by the governmental unit to the auditor (for example, deposit and loan balances). It is not designed to obtain information that the governmental unit would not ordinarily disclose (for example, contingent liabilities, security agreements). A separate request is sent to the governmental unit's account manager at the bank or other depository to elicit information on matters such as contingent liabilities. Investment balances with entities other than depositories should be confirmed directly with the custodians.

7.25 SAS No. 81 (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance concerning auditing procedures to be performed in gathering evidential matter related to assertions about investments. Among other things, it includes guidance on auditing investments carried at cost and fair

value. For investments carried at cost or amortized cost, the auditor should obtain evidence about the cost of investments. The procedures performed to obtain such evidence may include inspection of documentation indicating the purchase price of the security, confirmation with the issuer or custodian, and recomputation of discount or premium amortization. For investments carried at fair value, the auditor should obtain evidence corroborating the fair value. Quoted market prices obtained from financial publications or from national exchanges and the National Association of Securities Dealers Automated Quotations System (NASDAQ) are generally considered to provide sufficient evidence of the fair value of investments. However, for certain investments (that is, those that do not trade regularly), the auditor should consider obtaining estimates of fair value from broker-dealers or other third-party sources. Paragraphs 24 through 30 of SAS No. 81 (AICPA, *Professional Standards*, vol. 1, AU sec. 332.24–.30), include detailed guidance on auditing investments carried at fair value.

7.26 In addition, the auditor should consider performing procedures, as appropriate, relative to—

- Whether controls have been established and are in place over all activities and locations receiving, maintaining, and expending cash and investments.
- Whether there is compliance with legal or official authority for all depositories and investments.
- Whether interfund cash and investment transactions have been properly identified, classified, approved, and reported.
- Whether there is compliance with laws, regulations, and investment policies governing the deposit, investment, and collateralization of public funds.
- The adequacy of collateral.
- The appropriateness of the allocation of earnings and gains or losses from pooled cash and investments to individual funds.
- With regard to investments that are reported using cost-based measures, whether the liquidity requirements of the governmental unit will require sales of investments at a loss, which should be reported currently in the financial statements.

Chapter 8

Receivables and Revenues*

Introduction

8.01 Receivable and revenue transactions in governmental funds are closely related, and many audit procedures apply to both of them. Evidence supporting assertions in the balance sheet about receivables also supports assertions about revenues in the statement of revenues, expenditures, and changes in fund balance.

Nature of Transactions

8.02 In governmental funds, receivables usually arise as a result of revenue transactions. Governmental funds receive revenues from a variety of sources, including intergovernmental grants; taxes; and licenses and permits; and charges and fees collected in return for services. Interfund receivables may also be generated by the transfer or advance of resources between funds.

8.03 Governmental units sometimes provide capital improvements or services to benefit a particular group of property owners rather than the general citizenry by creating special assessment districts, providing or arranging financing, and billing and collecting the assessments. Revenues and expenditures for service-type special assessments are reported in a general, special revenue, or enterprise fund, as appropriate. Revenues and expenditures for capital-type special assessments are usually reported in a capital projects, debt service, or enterprise fund, as appropriate. See GASB Cod. sec. S40.

Accounting and Auditing Considerations

General Principles

8.04 According to GASB Cod. sec. 1600.106, revenues are recognized in the accounting period in which they become susceptible to accrual, that is, when they become both measurable and available (in this context *accrual* refers to the modified accrual basis of accounting). The term *available* generally means collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period. *Measurable* refers to the ability to quantify in monetary terms the amount of the revenue and receivable. GASB Cod. sec. 1600.128 states that transfers of financial resources among funds should be recognized in all funds affected in the period in which the interfund receivable(s) and payable(s) arise. Chapter 12, "Interfund Transactions and Fund Equity," describes the various types of interfund transactions.

* GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, establishes accounting and financial reporting standards for nonexchange transactions involving financial or capital resources (for example, most taxes, grants, and private donations). The principal issue addressed in GASB Statement No. 33 is the timing of recognition of nonexchange transactions. It is effective for financial statements for periods beginning after June 15, 2000, with earlier application encouraged. References to the recording of transactions addressed by GASB Statement No. 33 will be modified to conform to the requirements of GASB Statement No. 33 in a future edition of this guide. Paragraphs 8.17 through 8.24 provide a summary adapted from GASB Statement No. 33.

Receivables

8.05 *Revenue-Related Receivables.* GASB Cod. sec. 1600.107 through 1600.116 states that governmental fund revenues that usually can and should be recognized on the accrual (in this context, the modified accrual) basis, include property taxes, regularly billed charges for inspection or other routinely provided services, most entitlement and unrestricted financial assistance grants from other governments, and taxpayer-assessed taxes such as sales and income taxes. The property taxes due a government, net of estimated uncollectibles, typically can be determined and recorded in the accounts when levied. Deferred revenues, other than those arising from grants, are recorded when receivables are deemed to be measurable even though they are not available.

8.06 *Intergovernmental Financial Assistance.* Recognition of revenue from grants, entitlements, or shared revenues is described in GASB Cod. sec. G60.111–.113. Generally, entitlements and shared revenues are recognized as revenue when received or earlier, if measurable and available. Resources arising from grants are usually subject to restrictions. Therefore, most grant revenues are recognized as revenue only when the conditions of the grant are met. Grant funds received before eligible costs are incurred, including cost-sharing or matching requirements, are recorded as deferred revenue. Eligible grant-related expenditures or expenses incurred in the advance of cash receipts result in recording the related receivables and revenue. GASB Cod. sec. G60 establishes accounting and financial reporting standards for pass-through grants, food stamps, and on-behalf payments for fringe benefits and salaries.

8.07 *Interfund Transaction-Related Receivables.* Receivables are also created by loans or advances to other funds of the governmental unit, the generation of revenues in quasi-external transactions (such as payments in lieu of taxes due from an enterprise fund), and reimbursements due from other funds not received at the reporting date. Interfund transactions are described further in chapter 12. The assessment of collectibility of interfund receivables is the same as for any other receivable. If the receivable is not deemed collectible, in whole or in part, it should be written off or written down to net realizable value, and the transaction classified as an operating transfer or a residual equity transfer by each fund, depending on the substance of the original transaction.

Revenues

8.08 Some revenues are recognized when received in cash and, consequently, no receivable is recorded. Other revenues are accrued and related receivables are established. The following discussion describes the accounting and financial reporting practices applicable to several common sources of revenues for governments.

8.09 *Taxes.* Taxes are the major source of revenue for most governments. Recognition of tax revenue varies according to the type of tax because different types of taxes become measurable and available at different times.

8.10 *Property Taxes.* Property taxes are ordinarily considered available if they are levied and due before year end and collected within sixty days following the end of the year. Because of unusual circumstances, if the facts justify a period greater than sixty days, the governmental unit should disclose the period being used and the facts justifying that revenue recognition policy.

Recognition of property tax revenue is described in GASB Cod. sec. P70. Auditors should note that in November 1997, the GASB issued GASB Interpretation No. 5, *Property Tax Revenue Recognition in Governmental Funds*, which is an interpretation of NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, and an amendment of NCGA Interpretation 3, *Revenue Recognition—Property Taxes*. It is effective for financial statements for periods beginning after June 15, 2000, although earlier application is encouraged. The Interpretation modifies the definition of available as the term relates to property tax revenue recognition using the modified accrual basis of accounting. The effect of this amendment is to remove the “due” consideration from the definition of available established in NCGA Interpretation 3. It does not, however, change the stipulation that the collection period after year-end should not exceed sixty days (except in an unusual circumstance as described above).

8.11 Sales Taxes. GASB Cod. sec. 1600.110 requires that revenues from taxpayer-assessed taxes, such as sales taxes, net of estimated refunds, should be recognized in the accounting period in which they become susceptible to accrual—that is, when they become both *measurable* and *available* to finance expenditures of the fiscal period. Sales taxes collected by merchants but not yet required to be remitted to the taxing authority at the end of the fiscal year and taxes collected and held by one government agency for another should be accrued if they are to be remitted in time to be used as a resource for payment of obligations incurred during the preceding fiscal year.

8.12 Income Taxes. Many governments raise revenues through income taxes levied on wages, net income as defined by the taxing authority, or other transactions. GASB Cod. sec. 1600.110 requires revenue from taxpayer-assessed taxes, such as income taxes, net of estimated refunds, to be recognized in governmental funds in the accounting period in which they become susceptible to accrual—that is, when they become both measurable and available to finance expenditures of the fiscal period.

8.13 Licenses, Permits, and Other Similar Fees. Revenues from licenses, permits, and other similar fees usually are recorded when cash is received.

8.14 Services Financed by Special Assessments. Service-type special assessments do not result in the construction of assets and generally are not associated with the issuance of long-term debt. Service-type assessments often are established in response to limitations on property tax rates where basic services or additional services are provided to property owners on an assessment basis. The type of services provided under these arrangements include streetlighting and streetcleaning, weed cutting, and snow removal.

8.15 GASB Cod. sec. S40.114 states that revenues for service-type special assessments are recognized in a manner similar to that used for user fees. Both the assessment revenues and the expenditures (expenses) for which the assessments were levied should be recognized on the same basis of accounting as that used for the fund type in which the service-type special assessments are recorded. For governmental funds, recognition should occur when the revenues are measurable and available, that is, revenue should only be recognized in the amount of annual assessment installments as they become due and are billed to property owners. Any noncurrent installments should be recorded as deferred revenue in the governmental funds.

8.16 Receivables of all funds should be evaluated as to collectibility and, if necessary, allowances for estimated uncollectible amounts should be recorded.

Nonexchange Transactions

8.17 GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, issued by the GASB in December 1998, establishes accounting and financial reporting standards for nonexchange transactions involving financial or capital resources (for example, most taxes, grants, and private donations). In a nonexchange transaction, a government gives (or receives) value without directly receiving (or giving) equal value in return. The principal issue addressed in this Statement is the timing of recognition of nonexchange transactions.

8.18 GASB Statement No. 33 identifies four classes of nonexchange transactions based on shared characteristics that affect the timing of recognition:

1. *Derived tax revenues*, which result from assessments imposed on exchange transactions (for example, income taxes, sales taxes, and other assessments on earnings or consumption).
2. *Imposed nonexchange revenues*, which result from assessments imposed on nongovernmental entities, including individuals, other than assessments on exchange transactions (for example, property taxes and fines).
3. *Government-mandated nonexchange transactions*, which occur when a government at one level provides resources to a government at another level and requires the recipient to use the resources for a specific purpose (for example, federal programs that state or local governments are mandated to perform).
4. *Voluntary nonexchange transactions*, which result from legislative or contractual agreements, other than exchanges, entered into willingly by the parties to the agreement (for example, certain grants and private donations).

8.19 GASB Statement No. 33 also distinguishes between two kinds of stipulations on the use of resources: time requirements and purpose restrictions. Time requirements affect the timing of recognition of nonexchange transactions; purpose restrictions should not affect when a nonexchange transaction is recognized.

8.20 The timing of recognition for each class of nonexchange transactions is as follows (assuming the accrual basis, except where indicated for revenue recognition):

- **Derived tax revenues**
Assets—When the underlying exchange transaction occurs or resources are received, whichever is first.
Revenues—When the underlying exchange transaction occurs. (On the modified accrual basis of accounting, revenues should be recognized when the underlying exchange has occurred and the resources are available.) Resources received before the underlying exchange has occurred should be reported as deferred revenues (liabilities).
- **Imposed nonexchange revenues**
Assets—When the government has an enforceable legal claim to the resources or resources are received, whichever is first.
Revenues—In the period when use of the resources is required or first permitted by time requirements (for example, for property taxes, the

period for which they are levied), or at the same time as the assets if the government has not established time requirements. Resources received or recognized as receivable before the time requirements are met should be reported as deferred revenues. (For property taxes on the modified accrual basis, governments should apply NCGA Interpretation 3, as amended.)

- **Government-mandated and voluntary nonexchange transactions**
Assets (recipients) and liabilities (providers)—When all applicable eligibility requirements are met or resources are received, whichever is first. Eligibility requirements are established by the provider and may stipulate the qualifying characteristics of recipients, time requirements, allowable costs, and other contingencies.
Revenues (recipients) and expenses/expenditures (providers)—When all applicable eligibility requirements are met. (On the modified accrual basis, revenues should be recognized when all applicable eligibility requirements are met and the resources are available.) For transactions in which the provider requires the recipient to use (sell, disburse, or consume) the resources in or beginning in the following period, resources provided before that period should be recognized as advances (providers) and deferred revenues (recipients). For transactions, such as permanent or term endowments, in which the provider stipulates that resources should be maintained intact in perpetuity, for a specified number of years, or until a specific event has occurred, resources should be recognized as revenues when received and as expenses/expenditures when paid.

8.21 GASB Statement No. 33 also provides guidance on recognizing promises made by private donors, contraventions of provider stipulations, and nonexchange revenues administered or collected by another government.

8.22 GASB Statement No. 33 is effective for financial statements for periods beginning after June 15, 2000. Earlier application is encouraged. The provisions of GASB Statement No. 33 for accrual-basis revenue recognition cannot become effective for governmental activities until one or more Statements requiring accrual-basis accounting for those activities become effective. Under the existing financial reporting models, the modified accrual provisions of GASB Statement No. 33 should be used for governmental funds and expendable trust funds, and the accrual provisions should be used for proprietary funds; nonexpendable, pension, and investment trust funds; colleges and universities; and entities that use proprietary fund accounting.

8.23 GASB Statement No. 33 requires governments to recognize capital contributions to proprietary funds and to other governmental entities that use proprietary fund accounting as *revenues*, not contributed capital. However, governments should not restate contributed capital arising from periods prior to implementation of the Statement until the GASB issues one or more Statements requiring restatement of those prior-period balances.

8.24 Readers should refer to the full text of the Statement when considering accounting and reporting issues related to nonexchange transactions.

Financial Statement Presentation and Disclosure

8.25 The summary of significant accounting policies should describe the accounting principles used for recognizing all material revenues. The description of the property tax revenue recognition policy should follow the guidance

contained in GASB Cod. sec. P70. If intergovernmental grant revenues are subject to adjustment as, for example, when significant questioned costs may be identified in a grant compliance audit, the auditor should consider whether a loss contingency exists and, if so, whether a liability should be recorded or additional disclosure is required.

8.26 The amount of interfund receivables and payables, by fund, reported in the financial statements is a required disclosure, which generally is presented in a footnote. (See GASB Cod. sec. 2300.106 and chapter 12.)

Assertions

8.27 The categories of financial statement assertions and the specific audit objectives applicable for receivables and revenue are related as follows:

- *Existence or Occurrence.* Only revenues that are measurable and available in the fiscal period are recorded, and receivables representing amounts uncollected at the end of the period are valid.
- *Completeness.* Revenues that are available and measurable in the fiscal period and all receivables are recorded; some receivables may not result from revenue transactions.
- *Rights and Obligations.* The governmental unit has satisfied the relevant legal requirements to receive all revenues and receivables recorded.
- *Valuation or Allocation.* Revenues are billed or charged and recorded at the correct amount, and receivables are stated at the net realizable amount.
- *Presentation and Disclosure.* Revenues, receivables, and deferred revenues are properly classified by fund type in the financial statements, and related disclosures are made.

Internal Control and Auditing Considerations

8.28 The auditor determines the governmental unit's various revenue sources by reading legal documents, such as budgets, enabling legislation, and grant agreements; inquiring of responsible officials concerning sources of revenue; and reviewing the financial statements of the prior period. When the sources and amounts of anticipated revenues are identified, the auditor obtains a more detailed understanding of internal control over the processes for billing, collection, and receipt for the major revenue sources.

8.29 The portion of appendix B, "Illustrative Internal Control Questions—State and Local Governmental Units," that relates to revenues and receivables may be considered by the auditor in performing a risk assessment.

8.30 Additional internal control features related to specific sources of revenues and receivables include the following for property taxes:

- Periodic comparison of tax assessment rolls to real estate property files for completeness and proper jurisdictional boundaries
- Periodic redetermination of property assessments
- Annual reconciliation of the current year's roll to the prior year's roll
- Prompt updating of assessor's records for transfers of property
- Separation of the tax collection function from all other financial functions

- Establishment of and compliance with specific written procedures for abatements, exonerations, and refunds
- Vesting of authority to abate interest and penalties in an individual, independent of the tax collection function
- Totaling and comparing individual tax bills to total tax levy before mailing
- Agreeing recorded tax billings to total tax levy
- Establishment of appropriate billing, collection, and revenue recognition procedures for properties subject to payments in lieu of taxes
- Appropriate legal procedures for liens, tax sales, and foreclosures
- Authorization for disposal of parcels due to nonpayment of taxes, independent of the tax collection function

Internal control features related to sales, income, and other similar taxes, and intergovernmental revenues include—

- Maintaining a file of taxpayers, licensees, or permit holders and periodic and routine comparison of filed returns to the file to ensure that taxpayers are filing currently and with the appropriate jurisdiction.
- Conducting audits of tax returns on a scheduled basis.
- Establishing controls to assure that the compliance features of grants are monitored.

Audit Procedures

8.31 Account receivable balances are often small. Therefore, the audit approach to receivables in a governmental unit is often integrated with the substantiation of revenues. This audit approach frequently is the reverse of that of a business enterprise where substantiation of revenues is often a by-product of the audit of receivables.

8.32 Audit procedures are designed to achieve audit objectives and assure compliance with legal requirements, such as grant agreements, ordinances, and statutes. The auditor should consider the procedures outlined in the sections that follow when developing a plan for the audit of receivables and revenues.

Confirmations

8.33 Many receivables and revenues are susceptible to confirmation. Confirmation of receivables provides evidence about the existence and ownership of a receivable but provides little evidence about collectibility. Collectibility usually is evaluated through the examination of subsequent receipts and historical trends. In SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), see paragraphs 17 through 22, “Form of Confirmation Request” (AICPA, *Professional Standards*, vol. 1, AU sec. 330.17 through .22) and paragraphs 34 and 35, “Confirmation of Accounts Receivable” (AICPA, *Professional Standards*, vol. 1, AU sec. 330.34 and .35) for further guidance. In some cases, audit evidence is obtained more readily through the application of alternative audit procedures. However, if the confirmation of receivables is not performed due to the existence of one of the three conditions noted in paragraph 34 of SAS No. 67, the auditor must document how he or she overcame the presumption that receivables would be confirmed.

8.34 For intergovernmental grant revenue and tax revenue collected by other governmental units, the auditor may confirm the amounts transmitted to the governmental unit being audited during the fiscal period as well as the unremitted amounts to be recorded as receivables.

8.35 Normally, the confirmation of balances owed by individual taxpayers is not effective when the receivable balance for property taxes, special assessments, or other taxes is composed of many small balances. In such cases, response rates to properly designed confirmations may be inadequate or unreliable. However, as noted in paragraph 35 of SAS No. 67, the auditor must document why the use of confirmations would be ineffective.

8.36 For income tax revenue, the auditor considers the reasonableness of the estimation process used to record the estimated payable to or receivable from taxpayers as a group. Though it is usually not possible to establish conclusively whether all individuals or entities are paying all the income taxes due, the auditor considers whether reasonable efforts are being made to minimize nonpayment. Among the factors the auditor considers are internal control over the collection of current and delinquent income taxes, methods used for determining population completeness, frequently referred to as an *enforcement or discovery* (for example, whether all citizens are filing income tax returns), and the taxing authority's audit and follow-up procedures related to income tax returns filed.

Other Procedures

8.37 Other unique audit procedures related to property tax receivables and revenue may include—

- Comparing the current year's assessed value to that of prior years and obtaining explanations of significant changes.
- Reviewing the computation of the total assessed value for property.
- Recalculating the total tax levy.
- Summarizing tax revenue and comparing recorded revenue to the current budget and prior-period actual.
- Comparing the ratio of taxes collected to those of prior years.
- Reconciling ending receivable balance to beginning receivable balance, levy, supplements, collections, abatements, and exonerations.
- Reviewing abatements, exonerations, and refunds for proper approval.
- Determining whether the list of delinquent and uncollectible taxes, if required by law, was properly filed.
- Testing compliance with the legal requirements pertaining to the sale of property for nonpayment of taxes.
- Comparing the current year's revenue from tax sales of property with revenues from prior years.
- Determining whether property parcels are improperly omitted or exempted from the tax rolls by comparing current assessment rolls to a map of the government or prior assessment rolls. Alternatively, determining that the total land area of property within the government's boundaries or within special taxing districts is consistent with that of the prior year.

8.38 Audit procedures related to sales, income, and other taxes, governmental and other receivables, and revenues may include—

- Comparing the current year's actual revenue with the current year's budget and prior years' actual.
- Reviewing the reasonableness of the government's indirect cost allocation plan and determining the propriety of indirect cost items allocated to grant programs.
- Reviewing grant applications, agreements, contracts, budgets, and reports to determine that grant expenditures are in accordance with grant agreements.
- Reviewing grant records for material areas of noncompliance and questioned costs.
- For governments involved in matching fund grants, reviewing supporting documentation to support unit's contribution and determining allowability of any in-kind (goods or services) matching efforts to grant terms.
- Considering the propriety and consistency of revenue recognition principles.
- Evaluating the adequacy of liabilities for probable income or other tax refunds.

8.39 Audit procedures related to interfund transactions and receivables may include—

- Considering whether interfund transactions are properly approved.
- Evaluating whether the fund receiving an advance has the ability to repay the advance.
- Considering whether permanent interfund advances are recorded as equity transfers.
- Determining the amount of any interfund borrowing that has occurred indirectly through the use of pooled cash and investment accounts.
- Evaluating whether transactions are properly classified (see GASB Cod. sec. 1800).
- Considering whether fund balance reserves are established as appropriate.
- In the case of an internal service fund that is used to account for the government's risk financing activities and that has a significant deficit or balance in retained earnings, consider whether the internal service fund revenue and the served fund expenditures/expenses are adjusted over a reasonable period of time so that internal service fund revenues and expenses are approximately equal (GASB Cod. sec. C50.123). In circumstances other than risk financing in which an internal service fund has a significant deficit or balance in retained earnings, the guidance in GASB Cod. sec. C50 also could be considered.

Chapter 9

*Expenditures and Related Liabilities**

Introduction

9.01 In governmental fund accounting, the term *expenditures* is used to indicate decreases in financial resources or increases in current liabilities and, accordingly, is not limited to cash payments. The auditor should understand governmental fund expenditures and related liabilities and the unique reporting practices in government related to certain expenditures.

9.02 Generally, expenditures are classified according to character as current operating (for example, payroll, fringe benefits, or public safety administration), capital, intergovernmental, or debt service expenditures. Capital expenditures are discussed in chapter 10, "Capital Expenditures and Related Fund and Account Group Activity." Expenditures related to government grants and other assistance programs are discussed in SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (see appendix M). Debt service expenditures are discussed in chapter 11, "Debt and Debt Service." In addition, chapter 12, "Interfund Transactions and Fund Equity," discusses interfund transactions including expenditures made by one governmental fund for another governmental fund and interfund operating and equity transfers.

Nature of Transactions

9.03 The term *modified accrual basis of accounting* is used to describe expenditure and liability accounting in governmental funds for two reasons. First, the primary objective of accounting in governmental funds is to reflect the sources and uses of financial resources, not to allocate costs to the periods benefitted. To meet that objective, the measurement focus is on expenditures and not expenses. Second, in governmental fund accounting, the definition of *current liability*, as presented in GASB Cod. sec. 1600.119, differs from that used by business enterprises (see also GASB Cod. sec. 1500.103).

9.04 To assure that budgets are not overspent, most governmental units use an encumbrance system to track outstanding purchase commitments that have not yet resulted in liabilities. GASB Cod. sec. 1600.125 defines encumbrances as "commitments related to unperformed (executory) contracts for goods or services." When a purchase order contract is issued or any other commitment is made, the governmental unit reduces the amount of budgetary authority remaining in the budget category and records an outstanding encumbrance. When the goods or services are received, the encumbrance balance is reduced and the expenditure and liability are recorded.

* GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, establishes accounting and financial reporting standards for nonexchange transactions involving financial or capital resources (for example, most taxes, grants, and private donations). The principal issue addressed in GASB Statement No. 33 is the timing of recognition of nonexchange transactions. It is effective for financial statements for periods beginning after June 15, 2000, with earlier application encouraged. References to the recording of transactions addressed by GASB Statement No. 33 will be modified to conform to the requirements of GASB Statement No. 33 in a future edition of this guide. Paragraphs 8.17 through 8.24 provide a summary adapted from GASB Statement No. 33.

9.05 In governments, a warrant is an order issued by a legislative body or a responsible government official authorizing the governmental unit's treasurer to pay a specific amount to a specific person or to the bearer. A warrant may be payable on demand; in that case, a bank check is issued or a cash disbursement is made. A warrant may also be payable only out of certain revenues when and if those revenues are received; in that case, the warrant is recorded as an account payable.

9.06 An expenditure is usually recognized when the government has received and becomes liable for the payment for goods and services. That is, an expenditure is generally recognized in the period in which the amount can be objectively measured, the goods or services are delivered or received, and title has passed.

Accounting and Auditing Considerations

9.07 Accounts payable and related liabilities usually are substantiated in conjunction with operating expenditures. However, there are unique aspects of accounting for certain governmental fund expenditures and related assets or liabilities in the areas of inventory and prepaid items, long-term liabilities, joint costs, and encumbrances.

Payroll and Related Liabilities

9.08 Payroll expenditures include salaries, wages, and benefits (sick leave, vacation, and pension). (Guidance on accounting for compensated absences is provided in GASB Cod. sec. C60.) Personnel-related policy and procedure considerations include the following:

- Civil service requirements for hiring, promoting, and terminating employees
- Union contracts establishing wage rates and benefits
- Budgetary control over the number of employees authorized by department or function
- Permitted overtime

Grant agreements sometimes contain restrictions on the maximum salaries or wages and benefits that can be expended from, or charged to, that grant program.

Inventory and Prepaid Items

9.09 Under current governmental fund accounting principles, a government may record the resources used to purchase inventory or other prepaid items as an expenditure either when purchased or when consumed. That is often referred to as the purchase versus consumption option. Under the consumption method, items are recorded as assets when received and charged to expenditures as used. Some governments using the consumption method also elect to reclassify an amount equal to the year-end inventory on hand or prepaid items from unreserved and undesignated fund balance to a reserve for inventory or prepaid items. The intent of the reclassification is to demonstrate the extent to which the fund balance is composed of resources that are not available for other discretionary expenditures. Under the purchase method, items are initially recorded as expenditures. Inventory on hand is recorded as an asset with a corresponding credit to fund balance as reserve for inventory. (See chapter 12, for a discussion of reserves.) With regard to capitalization contributions (contributions sometimes made by state and local governmental entities to meet initial or ongoing capital minimums when forming a public entity risk pool), auditors should refer to GASB Cod. sec. C50.130–135 to determine whether these contributions should be recorded as prepaid insurance.

9.10 Inventory in governmental funds usually consists of materials and supplies used in the performance of the governmental function rather than materials that enter into the cost of a product that produces revenue. In that sense, the governmental fund inventory, if recorded, is similar to prepaid items. Accordingly, governmental fund inventories are generally not written down from cost to lower market values unless the usability of the inventory is affected by physical deterioration or obsolescence.

Purchasing

9.11 The compliance considerations pertinent to purchasing activities include whether competitive bidding is required and what requirements are imposed by local or state ordinances, bond covenants, and grant provisions. Many local ordinances or state statutes require competitive bidding for certain purchases in excess of a specified dollar amount (for example, \$5,000). Auditors should be alert to circumvention of competitive bidding requirements, by, for example, intentionally splitting large purchase orders to fall below the statutory limit, preparing purchasing specifications that are so restrictive that only one vendor is able to qualify, setting quantity levels sufficiently large to eliminate small vendors, or extending contracts with one vendor when other vendors are available to provide the needed goods or services. Consecutive purchase orders to the same vendor for amounts slightly below the statutory limit is one indication that the governmental unit is circumventing this requirement.

Encumbrances

9.12 Encumbrances represent neither expenditures nor liabilities. In many governments, encumbrances outstanding at the end of a period are carried forward as a reservation of fund balance, with a corresponding reduction in unreserved fund balance. (See chapters 6, "The Budget," and 12 for discussions of encumbrances.)

Joint Costs

9.13 Some governmental entities, such as governmental colleges and universities and governmental health care providers, solicit support through a variety of fund-raising activities. Sometimes fund-raising activities are conducted with activities related to other functions, such as program activities or supporting services. Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund raising. SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, establishes financial accounting standards for accounting for costs of joint activities. It also requires financial statement disclosures about the nature the activities for which joint costs have been allocated and the amounts of joint costs. It is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. SOP 98-2 is included in appendix L in its entirety.

Liabilities Resulting From Uninsured Risk

9.14 As a result of rising insurance costs, many state and local governments have elected not to purchase insurance coverage for a wide range of risks. Other governmental units have insurance policies that cover losses only

in excess of extremely high amounts, namely an umbrella or stop-loss type coverage. Each of those situations is often referred to as *self-insurance*. Because no insurance is involved, the term *self-insurance* is a misnomer and the policy is more accurately described as *risk retention*.

9.15 The types of risks involved include, but are not limited to, workers' compensation, automobile, general liability, and public officials' liability. Many of those risk areas involve a high occurrence of claims. Accordingly, at any given time, there are usually a significant number of claims in all phases of processing and adjudication. In addition, there will exist *incurred but as yet unreported* claims that usually are referred to as incurred but not reported (IBNR) claims. Whether a government elects to record such liabilities and costs directly in the general fund, individual funds, or through an established internal service fund, it is important that expected costs of the claims are properly recorded in the funds assuming the risks and that the recorded liabilities represent unreported as well as reported claims. GASB Cod. sec. C50 and FASB Statement No. 5, *Accounting for Contingencies*, discuss the accounting for contingent liabilities related to uninsured risks.

Amounts Resulting in Long-Term Liabilities

9.16 Any expenditure not paid for immediately results in a liability that is recorded as an account payable, an accrued liability, or a long-term liability. If the liability is payable currently, it is recorded in governmental funds as a current or fund liability, and a related expenditure is reported on the operating statement. However, portions of certain governmental liabilities, such as claims and judgments, capital and operating leases, compensated absences, special termination benefits, landfill closure and postclosure care, and pension costs, are not payable currently. The noncurrent portions of those liabilities are reported in the general long-term debt account group (GLTDAG) and no expenditure is currently recognized. (See GASB Cod. sec. 1500.103 and chapter 11, "Debt and Debt Service," for discussion on the GLTDAG.)

Financial Statement Presentation and Disclosure

Expenditures

9.17 Governmental fund expenditures are presented in two different statements, which are described in the following two paragraphs.

9.18 *A Combined Statement of Revenues, Expenditures, and Changes in Fund Balances—All Governmental Fund Types and Discretely Presented Component Units.* Expenditures are typically presented as current operating, capital, intergovernmental, and debt service expenditures. In addition, the operating expenditures are presented by function, such as general government expenditures or public safety expenditures. This statement presents revenues and expenditures on the modified accrual basis of accounting.

9.19 *A Combined Statement of Revenues, Expenditures, and Changes in Fund Balances, Budget and Actual—General and Special Revenue Fund Types (and similar governmental fund types of the primary government for which annual budgets have been adopted legally).* This statement presents a comparison of budget to actual for all governmental fund types for which annual budgets are adopted legally. In this statement, actual results are presented on the same accounting basis as the

budget, even though the budget basis may not conform to GAAP. The most frequently observed difference between budgetary accounting and GAAP is the budgetary treatment of outstanding encumbrances as expenditures. Other differences can result from other basis of accounting issues, timing, perspective, or entity (see chapter 6 for a discussion of budgets).

Encumbrances

9.20 Recording encumbrances as expenditures is not in accordance with GAAP. However, the combined statement of revenues, expenditures, and changes in fund balances, budget and actual—general and special revenue fund types, should present actual operating results on the same basis of accounting as the budget. Therefore, if the budget basis reflects encumbrances as expenditures, the actual expenditures in the budget and actual statement should also be prepared on a consistent basis (that is, actual expenditures in the statement shall also include encumbrances). The financial statements or notes are to include a reconciliation of the budgetary basis (non-GAAP) amounts to the financial statement basis (GAAP) amounts. (See GASB Cod. sec. 2400.113 to 2400.123.)

Liabilities

9.21 Current liabilities, commonly referred to as fund or short-term liabilities, are reported in the governmental fund balance sheet. However, as indicated previously, long-term liabilities are recorded in the GLTDAG.

9.22 Disclosure. The financial statements or the notes should include the disclosures described in GASB Cod. sec. 2300.

Assertions

9.23 The categories of financial statement assertions and the specific objectives applicable to expenditures and related liabilities are as follows.

- *Existence or Occurrence.* Recorded expenditures and cash disbursements are for goods or services authorized and received; payroll, wages, salaries, and benefits disbursements are made only for work authorized and performed.
- *Completeness.* Expenditures incurred for goods or services and related accounts payable are all identified and recorded.
- *Rights and Obligations.* Expenditures for goods or services are authorized and in accordance with the budget, applicable laws, regulations, or other requirements; payroll and related liabilities are computed using rates and other factors in accordance with contracts and relevant laws and regulations.
- *Valuation or Allocation.* Expenditures for goods, services, payroll, and related disbursements, and liabilities are recorded correctly and allocated properly, as to fund, budget category, account, period, and amount.
- *Presentation and Disclosure.* Expenditures for goods, services, payroll, and related liabilities are properly presented by fund type and budget category, and related disclosures are adequate.

Internal Control and Auditing Considerations

9.24 The portion of appendix B, “Illustrative Internal Control Questions—State and Local Governmental Units,” that relates to procurement and payables and to employee compensation may be considered by the auditor in performing a risk assessment.

9.25 Many governments use one system for purchasing, accounts payable, and disbursements regardless of the number of funds maintained by the governmental unit. Similarly, governments often use a single payroll system regardless of the work locations and numbers of funds maintained. In those situations, most of the expenditure testing for all parts of a government can be done on a single expenditure or payroll system. However, some governments establish separate purchasing, accounts payable, disbursements, or payroll systems for federal grants or large special revenue funds such as school districts. In either case, controls over purchasing activities should be sufficient to ensure compliance with competitive bidding or other requirements imposed by local or state law or ordinances, bond covenants, and grant provisions. The auditor should consider testing each significant system.

9.26 The audit objectives for expenditures and related liabilities are similar to the objectives in the commercial environment, that is, to obtain evidence that all expenditures incurred during the period are presented in the financial statements, and related liabilities at the end of the period have been identified and properly supported, recorded, and classified. In addition, the following objectives are unique to governments:

- Expenditures are in accordance with the approved budget, as to amount and purpose, and with other applicable regulations.
- Encumbrances are properly identified, supported, classified, and recorded.
- Applicable laws and regulations are complied with relating to purchasing, payroll, grants, bond covenants, and program authorizations.
- Expenditures made for federal or other grant programs are allowable and properly classified as to the grant from which the expenditure was made.

Chapter 10

Capital Expenditures and Related Fund and Account Group Activity

Introduction

10.01 Capital asset acquisitions for the benefit of governmental fund-type activities are generally accounted for in governmental funds and account groups. Such assets, known as general fixed assets, are capitalized and reported in the general fixed asset account group (GFAAG). Fixed asset activity in proprietary funds is discussed in chapter 13, "Proprietary Fund Types."

Nature of Transactions

10.02 Acquisitions of general fixed assets are recorded as expenditures in the general fund, special revenue funds, or the capital projects funds. Capital asset acquisitions are generally accounted for and reported based on the size and nature of the transaction, as described below, depending on the governmental unit's capital budgeting and capitalization policies:

- Small purchases of personal property, such as desks, furnishings, automotive equipment, and other small machinery and equipment used in the conduct of governmental fund-type operations, are usually shown as expenditures in the appropriate general or special revenue funds, and will be provided for in the operating budgets.
- Major projects, such as buildings, bridges, streets, parks, and storm drains, typically financed with the proceeds of bond issues, special assessment revenues, grants from other levels of government, or transfers from other funds, are often accounted for in separate project funds within the capital projects fund type.
- In some cases, assets purchased or constructed in the governmental fund types are subsequently transferred to a proprietary fund, where they are used in ongoing revenue-generating activities (for example, water and sewer lines constructed in conjunction with the operation of a utility).

Accounting and Auditing Considerations

10.03 In governmental funds, the costs associated with the acquisition of general fixed assets are recorded as current period expenditures of the respective fund. The same amount is normally recorded as an addition to general fixed assets in the GFAAG. Recording of infrastructure general fixed assets (for example, streets and storm drains) is optional according to GASB Cod. sec. 1400.109 because such assets are immovable and of value only to the government.

* GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, establishes accounting and financial reporting standards for nonexchange transactions involving financial or capital resources (for example, most taxes, grants, and private donations). The principal issue addressed in GASB Statement No. 33 is the timing of recognition of nonexchange transactions. It is effective for financial statements for periods beginning after June 15, 2000, with earlier application encouraged. References to the recording of transactions addressed by GASB Statement No. 33 will be modified to conform to the requirements of GASB Statement No. 33 in a future edition of this guide. Paragraphs 8.17 through 8.24 provide a summary adapted from GASB Statement No. 33.

10.04 GAAP provides for the GFAAG to maintain a continuing accountability for the general fixed assets acquired. Accordingly, when capital assets are recorded as expenditures in the governmental fund types, if they meet that governmental unit's capitalization policy, they are also recorded in the GFAAG as an increase in "general fixed assets."

10.05 Other considerations regarding the accounting for general fixed assets include—

- Donated fixed assets should be recorded in the fund to which they relate or in the GFAAG, as appropriate, at their estimated fair value at the time of acquisition (GASB Cod. sec. 1400.113).
- Capitalization of interest, as provided for in FASB Statement No. 34, *Capitalization of Interest Costs*, as amended by FASB Statement No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*, is permitted, but not mandatory (GASB Cod. sec. 1400.111).

Although permitted, most governmental units do not opt to record accumulated depreciation in the GFAAG. Since the GFAAG is only an account group with no operating activities and the expenditures are not capitalized in the governmental fund type, no allocation of the cost of such assets among fiscal periods is made in the form of depreciation. Recording depreciation in the GFAAG results only in an entry in the account group to increase accumulated depreciation and reduce the investment in general fixed assets.

General Fund

10.06 The annual operating budget of a governmental unit usually includes, as a separate category, the amounts that are authorized for acquiring capital assets financed with general government revenues. The expenditure of such budgeted funds is usually recorded in the general fund or in the capital projects fund. If the expenditures are recorded in the capital projects fund, the resources used from the general fund are recorded as an operating transfer out of the general fund and as an operating transfer into the capital projects fund.

Special Revenue Funds

10.07 Resources such as intergovernmental grants or special assessments, which are restricted for the acquisition of capital assets, can be recorded initially in a special revenue fund to provide a single source of accountability for all the moneys received. If capital assets are acquired with those moneys, however, the accounting is the same as that described above for the general fund.

Capital Projects Funds

10.08 Capital projects funds are used to account for the financial resources used for the acquisition or construction of major capital facilities other than those financed by proprietary or trust funds. The capital projects fund is generally used when the expenditures are financed with debt proceeds, special assessment revenues, or capital grants. This fund is also used when the acquisition or construction of a major capital facility will occur over several fiscal years or where it is legally mandated.

10.09 As with all governmental funds, the focus of accounting in capital projects funds is on the source and use of resources, rather than on matching revenues and expenditures. Resources accumulated in other funds for a specific project can be transferred to the capital projects fund immediately or as needed. Expenditures are recorded in the periods incurred.

10.10 Debt proceeds are recorded in the operating statement in the period debt instruments are issued, that is, on the closing date. At the time the bonds or other debt instruments are issued and the proceeds received, the liability is also recorded in the GLTDAG with an offsetting entry to an account such as “resources to be provided in future years,” representing the repayment requirements to be included in future years’ operating budgets to service the debt. However, no amounts are recorded until the debt instruments are issued. If a closing takes place prior to year end but proceeds are not received until early in the following year, a receivable should be established in the fund (and a corresponding liability in the account group) on the closing date.

10.11 Capital grant revenues, addressed in GASB Cod. sec. G60, are earned when all significant terms of the grant are met. Expenditure of moneys is usually the prime factor for determining allowability of the cost and, thus, compliance with grant terms. Therefore, revenues are recognized as expenditures are incurred. If the grant agreement provides for some level of cost sharing, revenue recognition is contingent on compliance with those requirements.

10.12 Other than for compliance with grant agreements, the matching of revenues and expenditures is not required; therefore, the fund balance of capital projects funds (as further discussed in chapter 12, “Interfund Transactions and Fund Equity”) usually represents resources earmarked for completion of capital projects in future years and is not available for other discretionary expenditures.

Leases and Installment Purchases

10.13 Many governments enter into lease purchase agreements, installment purchase contracts, or other forms of capital asset financing agreements. Lease accounting for general fixed assets is described in GASB Cod. sec. L20. The cost of the asset is recorded in the GFAAG and the principal amount of debt incurred (the lease or installment purchase liability), determined in accordance with FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted, is recorded in the GLTDAG as a liability. The aggregate purchase liability is simultaneously recorded as an expenditure and an “other financing source” in the operating statement of the general fund or other governmental fund type acquiring the asset. Payments under the financing or lease agreement are recorded in the same manner as other debt service payments.

10.14 Some financing lease agreements may contain a *nonappropriation*, *nonrenewal*, or *fiscal funding* clause to avoid classification as legal debt for debt limit or voter referendum purposes. Such a clause provides that, although the governmental unit will use its best efforts to make the lease payments, it may terminate the lease without penalty if its appropriating body does not allocate the necessary moneys for lease payments in future adopted budgets. This clause gives the financing the character of a one-year annually renewable lease and is not considered legal debt by a number of governmental units under the laws of their state. However, due to the nature of the property or equipment in performing essential services by the governmental unit, such agreements in many cases will meet all the criteria of a capital lease that should be capitalized for accounting and financial reporting purposes.

General Fixed Asset Account Group

10.15 It is essential to maintain records to demonstrate accountability for general capital assets acquired in governmental fund types, even though they are charged to expenditures as incurred in those funds. The GFAAG is used for this purpose. As expenditures are made in governmental fund types for capital assets acquired, the amount of the expenditure is capitalized in the GFAAG.

When these assets are disposed of, their cost is removed from the GFAAG. Proceeds received from the disposal normally are recorded in the general fund, although some bond indentures or applicable laws may require that the proceeds be recorded in a related debt service fund, special revenue fund, or capital projects fund.

10.16 To maintain adequate accountability, a governmental unit should conduct a periodic physical inventory of fixed assets and adjust the records accordingly.

Initial Fixed Asset Records

10.17 Because governments have accumulated fixed assets over many decades, without proper records, they may have difficulty complying with the requirement of GASB Cod. sec. 1400. However, fixed asset cost information is needed and GASB Cod. sec. 1400.112 permits the use of estimated historical costs in establishing initial property records. The extent and method of estimation should be disclosed in the notes to the financial statements.

10.18 To establish initial property records, a government may use outside professional assistance to appraise property or may perform the following procedures internally:

- Develop a reasonably complete and accurate inventory of personal property and equipment owned, including identification of asset descriptions and an approximation of the year of acquisition. This may require taking a physical inventory. An inventory of real property is normally established through the examination of land records.
- Determine the acquisition cost, based on records or estimation procedures. One procedure is to estimate costs based on acquisition dates and manufacturers' catalogs or other information obtained through professional appraisal firms. Another procedure is to estimate current replacement costs and discount the amount to estimated acquisition cost through the use of indexes.

Asset Transfers

10.19 Occasionally, assets originally acquired by a governmental fund may be transferred to a proprietary fund, or assets originally acquired by a proprietary fund may be transferred to a governmental fund. When an asset is transferred to a proprietary fund, the GFAAG is reduced by the cost of the asset. In the proprietary fund, the asset is capitalized and recorded as contributed capital at its original cost, less an amount equivalent to the depreciation that would have been recorded had the asset been initially recorded in the proprietary fund and, if warranted, by an amount to reduce the asset to its estimated utility value. When assets are transferred to a proprietary fund, any related debt in the GLTDAG to be serviced by the proprietary fund is also transferred. Similarly, assets may be transferred from a proprietary fund to the GFAAG. In such cases, the asset is recorded in the GFAAG by an entry to the appropriate asset and investment in general fixed asset accounts, and the related debt, if any, is recorded in the GLTDAG and resources to be provided accounts. The appropriate valuation to be recorded in the GFAAG for an asset transferred from a proprietary fund can be its original cost, even if it has been depreciated, or its net depreciated value at the time of the transfer. (See paragraph 13.12 for further discussion of asset transfers.)

Financial Statement Presentation and Disclosure

10.20 The presentation of assets capitalized in the GFAAG includes the following disclosures:

- Detail of general fixed assets, such as land, buildings, and equipment
- The basis for valuing assets, for example, the cost or estimated historical cost
- Whether infrastructure assets are included or excluded
- Whether accumulated depreciation is reported and, if so, the depreciable lives and methods of depreciation
- A reconciliation of changes in the GFAAG during the year

10.21 Other related disclosure requirements include the following:

- Capitalization of interest, if any, during construction
- Commitments under long-term construction projects
- Pertinent data regarding capital and operating leases

Assertions

10.22 The categories of financial statement assertions and the specific audit objectives applicable to capital expenditures and related fund and account group activity are:

- *Existence or Occurrence.* Property and equipment in the GFAAG represent a valid listing of the capitalized cost of assets purchased, constructed, donated, or leased and physically on hand.
- *Completeness.* Capital expenditures represent a complete and valid listing of all costs incurred by the acquiring fund of the property and equipment acquired during the period, and costs that meet the capitalization policy are excluded from repair and maintenance and similar expenditure accounts.
- *Rights and Obligations.* Capitalized costs and, if applicable, related depreciation associated with all fixed assets no longer owned or possessed are removed from the GFAAG.
- *Valuation or Allocation.* Property and equipment is stated at historical or estimated historical cost. Donated assets are recorded at their estimated fair value at the date of donation.
- *Presentation and Disclosure.* Capital expenditures are accounted for properly by fund type and fixed assets capitalized are classified properly by major classes of assets and related sources of funding, and related disclosures are adequate.

Internal Control and Auditing Considerations

10.23 The portion of appendix B, “Illustrative Internal Control Questions—State and Local Governmental Units,” that relates to capital assets may be considered by the auditor in performing a risk assessment.

10.24 Government fixed asset acquisitions, particularly large projects, typically involve complex legal, contractual, and administrative requirements. For example, there are often legal regulations governing bidding and contract-awarding procedures. Also, if funding is derived from a bond issue, there are often specific bond covenant compliance requirements. If part of the funding is derived from grants or other intergovernmental funds, or if another unit of government provides a portion of the funds for a project, consideration is given to any additional specific compliance requirements.

Audit Procedures

10.25 Most procedures for the audit of capital acquisitions and fixed asset records of a commercial enterprise apply to such transactions for a governmental unit. In addition, the auditor should consider performing procedures, as appropriate, relative to—

- Whether the entity has satisfactory title to fixed assets, whether any liens exist, or whether any fixed assets have been pledged.
- Whether all fixed asset expenditures are recorded, including capital leases and installment purchases.
- Whether recorded fixed assets exist, assets disposed of during the period are eliminated from the records, and proceeds, if any, from disposition are properly recorded.
- Whether capital expenditures comply with budgetary, legal, grantor, and contractual requirements.
- Whether special assessments for capital projects have been authorized appropriately and property owner assessments have been calculated properly and timely billed.
- Whether capital expenditures in the governmental funds result in the capitalization of an equivalent amount in the GFAAG.
- Whether depreciation, if recorded, is based on acceptable methods and reasonable lives, and is properly calculated.
- Whether transfers of fixed assets and related debt, if any, between the GFAAG and the proprietary funds have been recorded properly.

Chapter 11

Debt and Debt Service

Introduction

11.01 Governments borrow money on a short-term basis either to meet seasonal cash needs or in anticipation of long-term borrowings at later dates. They usually borrow on a long-term basis to finance fixed asset construction or infrastructure improvements, but may do so to meet other needs such as the initial funding of a risk-retention program, the payment of a claim or judgment, or the financing of an accumulated operating deficit.

11.02 Local governments customarily are presumed not to have implicit power to borrow. Their authority to borrow usually is contained in charters or state statutes. Such authority may also prescribe the form and general terms of permitted indebtedness. Frequently, approval by governing boards or voter referendums is required.

Nature of Transactions

Short-Term Borrowing

11.03 Governments conduct short-term borrowing in several ways. For example, they borrow using tax anticipation notes collateralized by specific future tax collections. Grant anticipation notes usually require pledges of the related grants receivable. Revenue anticipation notes usually are secured by future revenues from one or more specific sources as well as by unpledged assets of the governmental units.

11.04 Bond anticipation notes (BANs) are used primarily to provide interim construction financing and are usually retired with the proceeds of long-term debt. Terms of BANs are normally twelve months or less. They are frequently refinanced by replacement notes if the original notes mature before the long-term debt is issued. The issuance of the long-term debt may be delayed pending improvement in market conditions; however, in a governmental environment, long-term debt usually is issued prior to the start of construction.

Long-Term Borrowing

11.05 Governmental long-term debt includes general obligation bonds, revenue or limited obligation bonds, capital leases, and other obligations with long-term repayment schedules. (Revenue bonds are discussed in chapter 13, "Proprietary Fund Types.")

11.06 ***General Obligation Bonds.*** General obligation bonds pledge the full faith and credit of the government. Often, specific authorization for each issue of such bonds is required in addition to general statutory authority for issuance. For example, a statute may permit a government to issue general obligation bonds up to a certain maximum, known as the debt limit, but each issuance may require the prior approval of a senior governmental unit. Because future annual principal and interest payments are supported by the taxing power of the governmental unit, a referendum or prior voter approval is often required to permit additional taxation.

11.07 Revenue Bonds. Revenue or limited-liability bond authorization procedures are similar to those for general obligation bonds. Specific receipts, such as certain restricted revenues, user fees, or special taxes (for example, special assessments, gasoline tax, and highway or bridge tolls), are often pledged to repay such bonds. Tax-increment bonds sometimes are issued in connection with economic development projects where future property tax revenues to be generated by new development are pledged to pay for the obligations issued. Depending on the expectations for future revenues, the full faith and credit of the governmental unit may be pledged for such bonds.

11.08 Lease-Rental Bonds. These bonds are issued by a related special entity, either governmental or not-for-profit, to finance public facilities such as schools, jails, or airports that are leased under contract to the governmental unit. A typical example is an equipment purchase contract that provides for either installment payments over a period of years or a capital lease financed by use of certificates of participation (COPs). The governmental unit pays rent sufficient to service the annual principal and interest debt payments. By the inclusion of budgetary *fiscal funding* or cancellation clauses in the lease, the lease-rental bond frequently is used to avoid borrowing restrictions, including debt limits, on governmental units that normally would levy taxes to pay debt obligations. A fiscal funding or cancellation clause provides that if lease payments are not appropriated in any future year budget, the lease is canceled. Leases are discussed in GASB Cod. sec. L20.

11.09 Other Long-Term Obligations. Governmental units may have other long-term obligations that are not classified as debt, as defined in this chapter, such as obligations for pensions, employee benefits, special termination benefits, landfill closure and postclosure care, operating and capital leases, and other claims, judgments, and compensated absences, which are discussed in GASB Cod. secs. C50, C60, L20, P20, and T25. The long-term portion of those obligations should be included in the GLTDAG.

Guarantees and Other Commitments

11.10 In addition to formal debt, a governmental unit is often involved in guarantees, moral obligation, no-commitment, or so-called conduit indebtedness. The term *conduit* means that the sponsoring governmental unit undertakes no commitment to pay or guarantee the debt service payments, but merely gives the underlying obligor access to the tax-exempt market.

11.11 Guarantees. Guarantees relate to the debt issue of another entity, for example, a local governmental obligation guaranteed by a state.

11.12 Moral Obligations. A government may issue bonds for which another entity has assumed a moral responsibility that is not an enforceable promise to pay. An example is a debt issued by a local government for which the state government is obligated, in the event of default, to consider assuming responsibility for total repayment or to consider annually the necessity to provide the required debt service payments. Moral obligations are usually unenforceable unless authorization to pay is adopted by the state legislature.

11.13 No-Commitment Debt or Conduit Debt. A governmental entity may authorize the issuance of debt bearing its name for the benefit of a private entity that is not a component unit as defined by GASB Cod. sec. 2100, and for which it assumes no responsibility for repayment, for example, as in industrial development bonds. The proceeds from the sale of such debt usually

are used in the public interest, such as for home or hospital construction, or the expansion of a private business to increase employment, or the government's tax base. Normally, such debt is repayable only by the entities for whom the debt is issued. Conduit debt explicitly states the absence of obligation by the government other than possibly an agreement to assist creditors in exercising their rights in the event of default. GASB Cod. sec. C65 provides certain disclosure requirements for conduit debt obligations (see paragraph 11.32 for a description of the disclosure requirements).

Accounting and Auditing Considerations

Reporting Proceeds of Debt

11.14 The accounting procedures for recording governmental fund debt depend on whether the debt is short term or long term and whether the debt is a general obligation debt or specifically identified as an obligation of a proprietary fund.

11.15 Short-term obligations, generally with maturities of less than one year, are recorded directly as a liability in the governmental fund issuing the debt, consistent with the current operating measurement focus ascribed to governmental fund-type accounting. Proceeds received by a governmental fund in exchange for short-term debt are recorded as an asset of the fund with a corresponding credit to a fund liability; *other financing sources* are not reported in the operating statement. Some debt agreements have due-on-demand clauses even though future maturity dates are stated. A debt with a due-on-demand clause is recorded as a liability of the fund that is responsible for repaying the debt unless the debt meets the criteria of GASB Cod. sec. D30. BANs that meet the criteria of GASB Cod. sec. B50 and demand bonds or debt with a due-on-demand clause that meet the criteria of GASB Cod. sec. D30 are classified as long-term debt.

11.16 General long-term obligations are recorded in a separate set of accounts known as the GLTDAG and offset by two contra accounts: amount available in debt service fund and resources to be provided in future years. The fund balance of the debt service fund generally equals the contra account, "amount available in debt service fund," in the GLTDAG.

11.17 Proceeds received for long-term debt are recorded as an *other financing source* in the statement of revenues, expenditures, and changes in fund balance for the fund receiving the proceeds of the long-term debt, and the principal amount is recorded in the GLTDAG. All proceeds and costs of issuing the debt are recorded and no debt-related transactions are shown on a net basis. GASB Cod. sec. 1500 provides further guidance on the accounting for transactions related to the issuance of long-term obligations.

11.18 A discount on general long-term debt is reported through the recording of the actual proceeds in the receiving fund, but a premium received in excess of the face amount of debt is recorded as debt proceeds in either the receiving fund or related debt service fund. Accordingly, premium or discount on long-term debt issued by governmental funds usually is not amortized. The face amount of the obligation is recorded in the GLTDAG.

11.19 General obligation bonds collateralized by the taxing power of the government but expected to be retired from proprietary fund revenues should be reported as liabilities in proprietary fund financial statements rather than in the GLTDAG.

11.20 The financial statements should identify appropriately those elements of any indebtedness that is secured by the full faith and credit of the government.

Capital Leases and Installment Purchases

11.21 Capital leases and installment purchases, including COPs, also create long-term obligations. The present value of the minimum payments represents the amount of the initial debt. The accounting requirements for these types of transactions are contained in GASB Cod. sec. L20.

11.22 If the lessor is a component unit, as defined in GASB Cod. sec. 2100, such as a building authority created by the governmental unit solely to finance construction for the governmental unit, the component unit is blended with the governmental unit. In such cases, the debt of the lessor is reported as the debt of the governmental unit in the GLTDAG and the debt between the lessor and the governmental unit is eliminated. (Capital leases are further discussed in chapter 10, "Capital Expenditures and Related Fund and Account Group Activity," and capital lease arrangements and blended component units are further discussed in chapter 15, "Special Governmental Units," paragraphs 15.21 through 15.25, herein.)

Recording Principal and Interest Expenditures

11.23 The recording of governmental fund debt service payments depends on whether the debt is short term or long term. The payment of short-term debt is recorded in the fund in which the debt is recorded, as a reduction of the recorded liability.

11.24 A debt service fund is normally used to accumulate resources to be used to make debt service principal and interest payments on general obligation long-term debt. Financial resources often are provided in other governmental funds and transferred to the debt service fund through operating transfers.

11.25 Long-term debt usually requires annual principal and semiannual interest payments to outside fiscal agents or individual bond holders. The general long-term debt is recorded in the GLTDAG until a principal installment is due. On the due date, matured bonds are removed from the GLTDAG and recorded as an expenditure and liability of the applicable debt service fund or other paying fund. Interest expenditures for all general long-term debt are recognized in the accounting period in which they are due, rather than as they accrue. On the other hand, if debt service fund resources have been provided in the current year for payment of principal and interest due early in the following year, the expenditure and related liability may be recognized in the debt service fund and the debt principal removed from the GLTDAG.

11.26 A general obligation debt indenture may establish reserve fund requirements for the accumulation of debt service resources. Many general obligation bonds, including certain special assessment obligations, create separately identified tax levies collected in amounts that are sufficient and timely to meet the principal and interest payments when due. Though only required when mandated by law or agreement, an individual debt service fund is often established for each debt issue.

Advance Refundings and In-Substance Defeasances

11.27 If new debt is issued to repay existing outstanding debt (a refunding), the new liability (the refunding debt) is recorded in the GLTDAG. The proceeds from the new issue are recorded in the fund receiving the proceeds as

an *other financing source*—*proceeds of refunding bonds*. Most advance refundings result in defeasance of debt. When the old debt is defeased, it is no longer reported as a liability in the GLTDAG; only the new debt is reported. Payments to the escrow agent from resources provided by the new debt should be reported as an *other financing use*—*payment to refunded bond escrow agent*. Payments to the escrow agent from other resources of the entity should be reported as debt service expenditures. The accounting and disclosure requirements for refundings and defeasance of debt are described in GASB Cod. sec. D20.

Debt Limits

11.28 Most governmental units have some form of outstanding debt limitations imposed by state or local laws. These limitations can be all-inclusive for all forms of debt outstanding, or may be structured so there are separate limitations for different forms of debt (for example, general obligation, revenue, installment, and lease purchase), or be dependent on the purpose for which the debt was issued (for example, equipment, water and sewer, transportation). Other limitations on the form, type, or amount of debt are imposed by federal tax laws and related IRS regulations. Management is responsible for identification and compliance with applicable laws and regulations.

Arbitrage

11.29 The Internal Revenue Code (IRC) and arbitrage rebate regulations issued by the IRS require rebate to the federal government of excess investment earnings on bond proceeds if the yield on those earnings exceeds the effective yield on the related tax-exempt bonds issued. The Regulations provide guidance with respect to various aspects of the calculation, including certain spending exceptions that may apply if bond proceeds are spent rapidly enough. In addition, governmental units with general taxing powers that issue \$5 million or less in tax-exempt indebtedness during a calendar year are not subject to the rebate requirements in most cases; the \$5 million limit is increased by up to an additional \$5 million if the proceeds are used to construct public school facilities. For this purpose, tax-exempt indebtedness includes bonds and certain capital leases and installment purchases. Excess earnings must be rebated every five years or upon maturity of the bonds, whichever is earlier. Arbitrage liability should generally be calculated annually and practice supports recording the liability in the governmental fund that will make the payment or the GLTDAG.

Financial Statement Presentation and Disclosure

Presentation

11.30 The financial statements should reflect the following:

- Short-term debt is recorded as a liability in the issuing fund, except for BANs meeting the criteria of GASB Cod. sec. B50.
- Demand bonds meeting the criteria of GASB Cod. sec. D30 are recorded as long-term debt.
- Special assessment debt is recorded according to requirements of GASB Cod. sec. S40.
- General obligation long-term debt repaid from governmental funds is recorded in the GLTDAG and offset by two accounts: amount available in debt service funds and resources to be provided in future years.
- General obligation long-term debt repaid from proprietary funds is recorded in the related proprietary fund.

- The principal portion of capital leases is recorded as debt.
- The proceeds of general obligation long-term debt are recorded as an *other financing source* in the governmental fund receiving the use of the debt proceeds.
- Principal and interest payments on governmental fund debt are recorded as expenditures when payable in the fund designated to make the payments.

Disclosure

11.31 Financial statements should disclose the nature of any restrictions on assets related to any outstanding indebtedness. Other related disclosures may include the following:

- The maturity, interest rates, and annual debt service requirements to maturity for the short-term and long-term issues of outstanding indebtedness
- The issuance and payment of debt for the period
- Details of capital leases
- Amounts of authorized but unissued debt
- The existence of any significant bond covenants and liquidity agreements
- Violations of bond covenants
- The nature and amount of contingent and moral obligations, and no-commitment debt, and any actions by the government to extend an obligation to pay
- The amount of unpaid defeased debt
- The refunding of debt, including the difference between the cash flows to service the old debt and the cash flows to service the new debt, and the economic gain or loss resulting from the transaction
- The debt issued subsequent to the balance-sheet date but before the financial statements are issued
- An existing or anticipated inability to pay debt when due
- Information on derivatives and similar debt transactions as required in GASB Cod. sec. 2300.601

11.32 The financial statements should identify any outstanding indebtedness of others guaranteed by the government, even if the possibility of default is remote. Any governmental unit assuming a moral obligation should disclose such circumstances in the notes to its financial statements (see paragraph 11.12 for the definition of moral obligation). For any conduit debt, because a default may adversely affect the government's own ability to borrow, practice supports display or disclosure of the existence of such debt in the financial statements. At a minimum, GASB Cod. sec. C65 requires certain disclosures for conduit debt obligations. The required disclosures include a general description of the conduit debt transactions, the aggregate amount of all conduit debt obligations outstanding at the balance sheet date, and a clear indication that the issuer has no obligation for the debt beyond the resources provided by related leases or loans.

Assertions

11.33 The categories of financial statement assertions and the specific audit objectives applicable for debt and debt service expenditures can be related as—

- *Existence or Occurrence.* Debt is authorized and recorded in the proper fund type or the GLTDAG.
- *Completeness.* All indebtedness of the governmental unit is identified, recorded, and disclosed.
- *Rights and Obligations.* The governmental unit has complied with the provisions of indentures and agreements related to debt, including provisions on the use of proceeds.
- *Valuation or Allocation.* Debt service expenditures (principal and interest payable) are properly recorded, classified, and disclosed for current and future periods.
- *Presentation and Disclosure.* Debt and related restrictions, guarantees, and commitments are properly presented in the combined financial statements, and related disclosures are adequate.

Internal Control and Auditing Considerations

11.34 The auditor acquires an understanding of internal control over the authorization, issuance, and repayment of debt. This understanding considers the specific audit objectives for debt and debt service expenditures related to the financial statement assertions. Many audit objectives related to the debt of governments are similar to audit objectives for the debt of business enterprises. However, the governmental environment makes certain modifications of audit objectives necessary. The auditor should consider obtaining evidence that—

- New debt issues are properly authorized.
- Indebtedness, including liabilities incurred under court order, lease purchase agreements, and other commitments, is identified and properly recorded or otherwise disclosed in the financial statements.
- Debt is recorded in the proper fund or the GLTDAG.
- Debt and related interest payable are properly recorded and classified as to terms and payment status and disclosed in the financial statements.
- Taxes levied to service the debt are adequate.
- The governmental unit has complied with the provisions of indentures and agreements relating to indebtedness, particularly on the use of proceeds, including any restrictions on the use of those proceeds prior to expenditure for their intended purpose.
- Debt restrictions are properly disclosed in financial statements or notes.
- Guarantees and other debt commitments are properly disclosed.
- Arbitrage rebate liabilities have been computed and recorded as a liability.

11.35 There is a presumption that assets identified in the financial statements as restricted satisfy legal requirements or bond indentures, unless there is disclosure to the contrary. If assets restricted for debt retirement include amounts due from other funds or from unrestricted assets of the same fund, there is an implication of noncompliance with the requirement for restriction of the assets. In such situations, the independent auditor should consider the adequacy of the accounting, disclosures, and other reporting considerations.

Audit Procedures

11.36 Confirmations may be used to verify the following:

- Principal balances outstanding at the balance-sheet date
- Principal and interest payments to fiscal agents during the year and any cash held for payment of unrepresented bond or interest coupons
- Legal compliance of debt sales and the applicability of arbitrage restrictions with bond counsel or appropriate oversight government
- The existence of any restrictions, terms, and proceeds with the lender or underwriter
- Compliance with appropriate covenants with the trustee

11.37 In addition to procedures followed in auditing other enterprises, the independent auditor should consider the following audit procedures related to a governmental entity's debt:

- Review legislative proceedings and enactments, and inquire whether all debt bearing the name of the reporting entity or any of its component entities is identified and is properly disclosed in the financial statements and notes.
- Review documentation and transactions for support of the intent and ability to pay general obligation debt from proprietary funds.
- Examine significant lease agreements for conditions requiring the capitalization of assets and related liability.
- Obtain information as to the existence of any guarantees or commitments related to the issuance of debt of other organizations.
- Review sinking fund calculations to determine the reasonableness of amounts accumulated to service debt.
- Review loan and debt agreements to determine whether any assets are pledged and if there are any restrictive covenants.
- Evaluate whether the governmental unit is in compliance with provisions of indentures and restrictive covenants, including provisions on the use of proceeds.
- Review the disposition of interest-earning and unexpended debt proceeds for compliance with bond covenants or legal statutes.
- Review procedures for calculating and recording any arbitrage rebate liability.
- Review the debt limit calculation and computation of any special tax levy-related debt service payments.

Chapter 12

Interfund Transactions and Fund Equity

Introduction

12.01 The need to properly account for and report interfund transactions and relationships and the composition of fund equity balances is unique to the governmental fund accounting environment. GASB Cod. sec. 1800 provides guidance regarding the classifying and reporting of interfund transactions and fund equity balances.

Nature of Transactions

12.02 Interfund transactions are divided into two categories with various subcategories. The first is revenues and expenditure/expense transactions consisting of reimbursements and quasi-external transactions. The second is the reallocation of resources transactions consisting of temporary interfund loans or advances, permanent residual equity transfers, or operating transfers. In addition, asset or liability accounts are used to record short-term amounts owed to one fund by another fund within the same reporting entity, or for goods or services rendered, where one fund incurs the liability for an expenditure/expense chargeable to another fund.

12.03 The equity of governmental fund types is classified as the fund balance and is composed of either reserved or unreserved balances. Generally, reserves are established to indicate a claim against assets or to identify certain assets not available for appropriation. The unreserved portion is further classified as designated or undesignated. The designations of fund balances originate through actions of either the executive or legislative branches of the governmental unit and indicates the tentative future use of available resources. Designations should be distinguished clearly from reserves, since managerial plans are subject to change and may never be legally authorized or result in expenditures.

Accounting and Auditing Considerations

Interfund Transactions

12.04 Interfund revenue and expenditure/expense transactions fall into the following categories:

- ***Reimbursements.*** Transactions that constitute reimbursements of a fund for an expenditure/expense initially made from it that is properly applicable to another fund. For example, an expenditure properly chargeable to a special revenue fund was initially recorded in the general fund, which, when subsequently reimbursed, is recorded as an expenditure in the special revenue fund and as a reduction of the expenditure account in the general fund. The interfund reimbursement accounting method is not used to record transactions that properly represent transfers between funds.
- ***Quasi-External Transactions.*** Transactions that would be accounted for appropriately as revenue and expenditures or expenses, if they involved organizations *external* to the governmental unit. Examples

include payments in lieu of taxes by an enterprise fund to the general fund, employer contributions from the general fund to the employer pension trust fund, internal service, or enterprise fund charges to other funds for goods or services based on established user charges.

12.05 Reallocation of resources-type transactions consists of the following:

- *Interfund Loans or Advances.* These are the transfer of moneys between funds within the same entity, usually for working capital purposes with the expectation of repayment, where no goods were sold or services rendered.
- *Residual Equity Transfers.* These are the nonrecurring or nonroutine transfer of equity between funds. In the governmental fund types, residual equity transfers are reported on the operating statement as additions to or deletions from the beginning fund balance. In the proprietary fund types, residual equity transfers are reported as additions to contributed capital, or as reductions of contributed capital or retained earnings, as appropriate.
- *Operating Transfers.* These are all other legally authorized interfund transfers, other than residual equity transfers, from a fund receiving revenue to a fund through which resources are expended. Examples include the transfer of tax revenue from the general fund to the debt service fund for debt service payments, the transfer of highway toll revenue from a special revenue fund to the capital project fund for the construction of a fixed asset, and the transfer of an operating subsidy from the general fund to an enterprise fund to support operations. Operating transfers are neither revenue, expenditure, nor expenses, and, therefore, are classified as *other financing sources/uses* in the operating statement in the governmental fund types and in a separate subsection before net income in the proprietary fund types.

Fund Balance

12.06 The total fund balance is subdivided into two categories, as applicable, reserved and unreserved.

12.07 *Reserved Fund Balances.* Reservations of fund balance are established to indicate that a portion of the fund balances is (a) legally segregated for a specific use (for example, a contractual commitment to third parties that has not materialized as a liability at the balance sheet date), or (b) not appropriable for expenditure because the underlying net asset is not an available financial resource for current appropriation or expenditure (for example, inventories, prepaid items, noncurrent receivables, or interfund advances). Such reserves are not intended as valuation allowances, but merely demonstrate the current unavailability of the assets to pay current expenditures. If a valuation allowance is required, it is presented as a reduction of the carrying amount of the asset. In addition, if the collectibility of an interfund receivable is doubtful, consideration is given to reclassifying the amount as a transfer.

12.08 *Unreserved Fund Balances.* Unreserved fund balances can be subdivided into designated and undesignated.

12.09 *Designated.* Designations indicate tentative management plans for the future use of certain financial resources that may never be legally authorized or result in expenditures. Examples of such designations include the amount to be included in the next year's budget for appropriations, available for completion of capital projects, and earmarked for unknown contingent

liabilities. Generally, designations are supported by definitive plans and approved by the governmental unit's senior management. Designations should not result in negative undesignated balances being reported on the financial statements. In such cases, disclosures of designations can be included in the footnotes.

12.10 Undesignated. The fund balance remaining after the reduction for reserved and designated balances is identified as the undesignated fund balance. This amount generally is equal to the amount available for future budget appropriation. However, state laws may establish minimum amounts that are accumulated before undesignated fund balances are available for appropriation and/or maximum amounts that are permitted before appropriation of any balance is required.

Reserve for Encumbrances

12.11 Encumbrances (discussed previously in chapters 6, "The Budget," and 9, "Expenditures and Related Liabilities"), represent commitments related to unperformed contracts for services and undelivered goods. If encumbered appropriations (budget authorizations) do not legally lapse, an amount equal to those encumbrances outstanding at year end is reclassified from the unreserved and undesignated fund balance to a *reserve for encumbrances* as a demonstration of future contractual claims against the fund balance.

Reserves for Inventory, Prepaid Items, and Long-Term Assets

12.12 Reserves for inventory, prepaid, and long-term assets are established to convey that such assets are not available for appropriation. Although, as noted in chapter 9, establishing reserves for inventory and prepaid items determined using the consumption method is optional, reserve accounting is required in cases where long-term assets are present. Governments using the purchase option for inventories should record the change in the required reserve as a change in fund balance.

12.13 The aggregate fund balance of any fund is not changed by the fact that a governmental unit has, or does not have, reserves or designations. Only the financial statement presentation of the components of total fund balance is affected by the presentation of any reserves or designations.

12.14 Changes in the aggregate fund balances can result from any of the following:

- Excesses (deficits) of revenues and other financing sources over (under) expenditures and other uses
- Changes in inventories accounted for using the purchases method
- Residual equity transfers as defined in GASB Cod. sec. 1800.106
- Prior period adjustments
- Changes in accounting principles

Financial Statement Presentation and Disclosure

Fund Balance

12.15 An example of the presentation of the fund balances of a governmental entity is presented in GASB Cod. sec. 2200.903, example 1. In addition to previously described reserves and designations, which relate principally to the general fund, the fund balances of other governmental fund types can have amounts classified as reserved or designated. Reserves and designations in

such funds may relate to identified portions intended for a particular purpose or to the fact that the total balance is restricted for the purpose of the fund type. However, many governmental units do not classify such balances as reserved or designated on the basis that the nature of the respective fund types provides adequate information regarding intent. The following additional comments relate to other governmental fund types.

12.16 *Special Revenue.* Fund balance reserves and designations can apply to special revenue funds. Negative balances in such funds are rare because encumbrances and expenditures are not usually incurred in advance of the receipt of revenues or an event (signed grant agreement) that would support the accrual of revenues equivalent to the expenditures incurred.

12.17 *Debt Service.* The fund balance of debt service funds is held only for meeting debt service requirements composed of principal, interest, and fiscal charges and can be categorized as reserved or designated for debt service. The fund balance of this fund type usually determines the *amount available in debt service funds* shown in the GLTDAG.

12.18 *Capital Projects.* Capital projects funds are used to demonstrate compliance with legal and contractual provisions and to compile certain cost data in the construction of major capital facilities. The fund balance usually represents unexpended resources designated or reserved for specific projects.

Changes in Fund Balance

12.19 GASB Cod. sec. 2200.113 requires the presentation of *changes in fund balances on the combined statement of revenues, expenditures, and changes in fund balances—all governmental fund types and discretely presented component units*. The fund balance reconciled in that statement may be either the unreserved or the total fund balance (GASB Cod. sec. 2200.904(b)). If the statement presents changes in total fund balance, material changes in each reserve and designation should be disclosed in notes to the financial statements.

Other Note Disclosures

12.20 Note disclosures should include identification of a negative fund balance in any individual fund and the plans for how it will be liquidated. Designated or reserved balances not evident in the financial statements should be presented in the notes.

Assertions

12.21 The categories of financial statement assertions and the specific audit objective applicable for interfund transactions and fund equity are related as follows:

- *Existence or Occurrence.* All recorded interfund transactions, and changes in reserved, designated, and undesignated fund balance are based on actual transactions between funds or are in accordance with any contractual or legal requirements.
- *Completeness.* All interfund transactions and reservations and designations of fund balance are identified, recorded, and disclosed.
- *Rights and Obligations.* Reserves required by law or contractual agreement comply with contractual or legal restrictions. Interfund transactions are in accordance with budget, legislative, or management authorizations, as applicable.

- *Valuation or Allocation.* Interfund transactions are recorded at the correct amounts in the proper funds and are valued at appropriate amounts.
- *Presentation and Disclosure.* All balance-sheet interfund balances between funds are reconciled and disclosed, and all reserves and designations are properly classified and adequately described.

Internal Control and Auditing Considerations

12.22 The auditor acquires an understanding of the internal control over interfund and fund balance transactions. This understanding considers the nature of all significant types of transfers and changes in fund balance to perform a risk assessment and determine the applicable audit procedures for each.

12.23 The auditor may need to consider the following specific audit objectives, selected controls, and auditing procedures.

Interfund Transactions

12.24 The principal objectives of the audit of interfund transactions include obtaining evidence that—

- Transactions between funds representing reimbursements or quasi-external transactions are properly classified, reported, and disclosed in the financial statements.
- Transactions between funds representing the reallocation of resources are properly authorized through legislative or budgetary actions and are properly classified, reported, and disclosed in the financial statements.

Fund Balance

12.25 The principal objectives of the audit of fund balances include obtaining evidence that—

- All fund balances and related transactions are reported in the financial statements in conformity with GAAP and in compliance with state and local regulations or requirements.
- The components of fund balance are properly classified and described.
- Reserves and designated balances are properly authorized.

Audit Procedures

12.26 For interfund transfers, the auditor should consider performing procedures, as appropriate, relative to—

- Whether all interfund transactions have been properly identified and classified by type within the financial statements.
- Whether transfers of resources are properly authorized, classified, and documented.

12.27 For reserved and designated fund balances the auditor should consider performing procedures, as appropriate, relative to—

- Whether documentation exists supporting all required reserved fund balances.

- Whether required reserved fund balances are established; these may create a negative (deficit) unreserved fund balance.
- Whether a reserve for encumbrances is required or whether encumbrances lapse at year end under state law, local charter requirements, or other regulations.
- Whether documentation exists to satisfy the requirement that designations are required or approved by either the chief executive officer or the legislature.
- Whether the designations of fund balances do not create or increase a negative unreserved and undesignated fund balance at the balance-sheet date regardless of the amount of fund balance that existed at the time of making the designation.
- Whether the designations of fund balances recorded represent demonstration of future expenditure intentions as distinct from unperformed (executory) contracts that should be reported as encumbrances.
- Whether reserved and designated fund balances represent only classification of aggregate fund balances and are not used to absorb future charges or credits.
- Whether reserved and designated fund balances no longer required are returned to the unreserved and undesignated fund balance.

Part III
The State and Local Government Audit—
Proprietary and Fiduciary Funds

Chapter 13

Proprietary Fund Types*

Introduction

13.01 The proprietary funds used to account for a government's ongoing activities are similar to those found in the private sector and consist of *enterprise funds* and *internal service funds*.

Nature of Transactions

Enterprise Funds

13.02 Enterprise funds account for operations that are financed and operated much like private business enterprises, meaning that the governing body has decided one of the following:

- a. The intention is that the costs (expenses, including depreciation) of providing goods and services to the general public on a continuing basis are to be financed or recovered primarily through user charges.
- b. The periodic determination of revenues earned, expenses incurred, and net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes. See GASB Cod. sec. 1300.104b(1).

13.03 Examples of enterprise funds in which user fees usually are charged to recover the costs of rendering services include the following:

- Public utilities (for example, water, sewer, gas, electric, storm water, trash, and garbage disposal)
- Recreation and cultural operations (for example, stadiums, arenas, sports facilities, convention centers, swimming pools, golf courses, and amusement parks)
- Services (for example, parking garages, toll facilities, airports, and public docks)
- Public entity risk pools

13.04 Examples of enterprise funds used to measure periodic revenue or expense determination, capital maintenance, or to achieve separate accountability may include—

- Hospitals and health care facilities
- Transportation activities for which fare collections usually do not cover costs, and subsidies from other funds or operating grants from other governments generally are necessary to sustain operations

* GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, establishes accounting and financial reporting standards for nonexchange transactions involving financial or capital resources (for example, most taxes, grants, and private donations). The principal issue addressed in GASB Statement No. 33 is the timing of recognition of nonexchange transactions. It is effective for financial statements for periods beginning after June 15, 2000, with earlier application encouraged. References to the recording of transactions addressed by GASB Statement No. 33 will be modified to conform to the requirements of GASB Statement No. 33 in a future edition of this guide. Paragraphs 8.17 through 8.24 provide a summary adapted from GASB Statement No. 33.

- Housing and urban redevelopment activities in which tenant rentals or land rates cover only a portion of costs, and subsidies or operating grants are necessary to meet operating expenses
- Food service programs of school districts

Internal Service Funds

13.05 Internal service funds are used to account for goods or services provided by a central service department or agency to other departments, agencies, or component units of the governmental unit, or to other unrelated governmental units, usually on a cost reimbursement basis. Accordingly, revenue and other financial resources of these funds should recover expenses, including depreciation. (See GASB Cod. sec. 1300.104b(2).)

13.06 Examples of internal service fund activities include the following:

- Communications servicer (telephone and mail)
- Data processing
- Printing and duplication
- Motor pools and maintenance operations
- Central supply stores
- Building occupancy and maintenance
- Risk retention

Accounting and Auditing Considerations

Generally Accepted Accounting Principles

13.07 GAAP for proprietary funds are generally those applicable to similar businesses in the private sector; the measurement focus is on the determination of net income, financial position, and cash flows. All assets, liabilities, equities, revenues, expenses, and transfers relating to the government's business, including fixed assets and long-term debt, are accounted for in a single proprietary fund rather than in a series of funds and account groups.

13.08 SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), describes the hierarchy of pronouncements applicable to governmental entities. GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, provides guidance on accounting and financial reporting for proprietary funds and entities that use proprietary fund accounting and reporting. Proprietary funds should apply all applicable GASB pronouncements as well as the following pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Statements and Interpretations of the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB) Opinions and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedure. In addition, a proprietary fund may also apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements. That is, a proprietary fund should apply either all or none of the FASB pronouncements issued after November 30, 1989. The same application of FASB pronouncements is encouraged to be used for all proprietary funds, including component units, in the general-purpose financial statements of the financial reporting entity.

Billings and Customer Receivables

13.09 Governments usually bill utility customers on cycle dates on a monthly or multimonthly billing basis. Cycle billing may result in material unbilled receivables at the end of an accounting period. For example, if meters are read and billed quarterly on cycle dates spread evenly throughout the quarter, an average of forty-five days' service for the entire customer base is unbilled at the end of the accounting period. However, consideration is required as to the characteristics of the billing period, such as seasonal usage. Proprietary funds should record estimated unbilled services, if material.

Customer and Developer Deposits

13.10 Many utility-type enterprise funds require customer deposits to assure timely payment for services. Deposits are normally required before service starts and are refunded when service is terminated. Land developers may also be required to make good-faith deposits to finance the cost of extending utility service lines.

13.11 Unearned deposits from customers and developers are initially recorded as liabilities in proprietary funds. Customer deposits remain in liabilities until they are applied against unpaid billings or refunded to customers. Developer deposits are reclassified as contributed capital or recognized as revenue when they are no longer refundable. The accounting for such deposits is being addressed in the GASB's financial reporting model project. With regard to capitalization contributions (contributions sometimes made by state and local governmental entities to meet initial or ongoing capital minimums when forming a public entity risk pool), auditors should refer to GASB Cod. sec. C50 to determine whether these contributions should be recorded as deposits.

Property, Plant, and Equipment

13.12 Fixed assets are constructed or acquired by proprietary funds from existing resources, capital contributions or grants, or borrowed funds. Fixed assets also are acquired or constructed in capital projects funds and contributed to proprietary funds. Assets acquired through other funds in prior years and recorded in the GFAAG are sometimes later contributed to a proprietary fund. The latter is especially likely in the case of newly established proprietary funds. Assets transferred from the GFAAG after some portion of the economic life of the assets has expired are recorded in the proprietary fund at original cost less an amount equivalent to the depreciation that would have been recorded had the asset been initially recorded in the proprietary fund and, if warranted, by an amount to reduce the asset to its estimated utility value. Fixed assets that are transferred from proprietary funds to the GFAAG are removed from the proprietary fund at book value, that is, no gain or loss is recognized in the proprietary fund. (See chapter 10, "Capital Expenditures and Related Fund and Account Group Activity," paragraph 10.19 for further discussion of asset transfers.)

13.13 When appropriate, interest incurred to construct a fixed asset should be capitalized in accordance with FASB Statements No. 34, *Capitalization of Interest Costs*, and No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*. The accounting policy with respect to capitalization of interest should be disclosed and consistently applied.

Long-Term Debt

13.14 Proprietary funds, particularly utility-type enterprise funds, frequently finance capital construction by issuing general obligation bonds or revenue bonds. Revenue bonds usually are repayable solely from pledged revenues—hence, the name revenue bonds—or they are sometimes referred to as *double-barreled* bonds, when, in addition to the pledged revenue stream, they are secured by a pledge of the full faith and credit of the issuing governmental entity.

13.15 Regardless of the type of security, general obligation bonds and revenue bonds (and similar hybrid debt issues) are recorded as liabilities of the proprietary fund that initiates the issuance of the bonds, benefits from the proceeds, and will repay the debt. Revenue bonds or general obligation bonds repayable by a proprietary fund are not recorded in the GLTDAG.

13.16 Most revenue bond indentures restrict the use of unexpended bond proceeds, and many restrict other activities of the issuer. For example, many indentures restrict the use of bond proceeds to the construction or acquisition of specific assets. Other restrictions include the maintenance of prescribed net income levels or requirements to use all or a portion of the fund's net operating income in meeting current debt service payments. A sinking fund is often required to set aside resources for the payment of future debt service obligations. Other covenants may set forth requirements for the disposition of any unused proceeds of the bond issue after construction is completed. Adequate disclosure is required in the financial statements or footnotes of any significant restrictions.

13.17 Refer to chapter 11, "Debt and Debt Service," paragraph 11.29 for a description of arbitrage requirements under the Tax Reform Act of 1986. Any liability for arbitrage payable to the federal government for debt recorded in a proprietary fund should be recorded as a liability of that fund.

Contributed Capital

13.18 The contributed capital of proprietary fund types is often provided by contributions from (a) other funds of the governmental unit, (b) grants from senior governmental units (generally the state or federal government), or (c) utility system developers or users.

13.19 The use of capital grant funds received from other governmental units or organizations may be restricted to the construction or acquisition of specific fixed assets or other specific expenditures. Capital contributed by developers or users may be received in the form of assets or facilities other than cash (for example, utility system distribution lines).

Depreciation on Fixed Assets Financed by Contributed Capital

13.20 The proprietary fund's records should identify all fixed assets where the source of financing is contributed capital. The source of a fund's capital is an important consideration in its rate-setting process. The depreciation expense related to assets financed by capital grants is recorded in the income statement, but a governmental unit may elect to close such depreciation to contributed capital rather than to retained earnings. If this option is elected, pursuant to GASB Cod. sec. G60.116, the closeout of the depreciation is recorded by debiting contributed capital and crediting retained earnings. This entry is reflected on the income statement immediately following net income.

Revenue and Expense Determination

13.21 Revenue for goods and services provided to other funds is recorded by the fund providing the goods or services, and expenses or expenditures, as appropriate, are recorded by the fund receiving the goods or services.

13.22 If costs related to the operations of a proprietary fund are paid by another fund (for example, employee fringe benefits paid by the general fund) and reimbursed by the proprietary fund, they are recorded in accordance with GASB Cod. sec. 1800.103b.

13.23 If a proprietary fund provides rate-regulated services of the type and under the conditions contemplated in FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, the provisions of that pronouncement may be considered. Pronouncements related to FASB Statement No. 71 may also be applicable using the guidance in GASB Statement No. 20.

Systems Development Fees

13.24 Fees charged to join an existing utility system or for the extension of an existing utility system are commonly referred to as *tap fees*, *connection fees*, or *systems development fees*. In some instances, fees related to the physical connection to the system are recorded as operating income, and the related costs are expensed. In other cases, amounts assessed that substantially exceed the cost to connect are recorded as contributed capital or the entire tap fee is recorded as nonoperating revenue. Additionally, the GASB has addressed nonexchange transactions in GASB Statement No. 33.* Exchange transactions will be addressed in the GASB's reporting model project.

Intergovernmental Grants

13.25 Grants, entitlements, and shared revenues received by proprietary funds for operating purposes or that may be used in support of either current operating expenses or capital facility acquisition at the discretion of the recipient government are recorded as *nonoperating revenues* immediately before net income in the accounting period in which they are earned and become measurable. Those restricted for the acquisition or construction of capital assets are recorded as contributed capital. GASB Cod. sec. G60 establishes accounting and financial reporting standards for pass-through grants, food stamps, and on-behalf payments for fringe benefits and salaries.

Interfund Transactions

13.26 Refer to chapter 12, "Interfund Transactions and Fund Equity," for a description of interfund transactions. Charges for services (for example, utility or usage) and payments in lieu of taxes are reported as quasi-external transactions. Operating transfers in (out) are reported immediately before net income. Residual equity transfers in (out) are reported as increases (decreases) in contributed capital, although residual equity transfers out may also reduce retained earnings.

* GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, establishes accounting and financial reporting standards for nonexchange transactions involving financial or capital resources (for example, most taxes, grants, and private donations). The principal issue addressed in GASB Statement No. 33 is the timing of recognition of nonexchange transactions. It is effective for financial statements for periods beginning after June 15, 2000, with earlier application encouraged. References to the recording of transactions addressed by GASB Statement No. 33 will be modified to conform to the requirements of GASB Statement No. 33 in a future edition of this guide. Paragraphs 8.17 through 8.24 provide a summary adapted from GASB Statement No. 33.

13.27 Proprietary funds may provide services to other funds that are recorded as revenues and expenses if they involve user charges similar to those charged to parties outside the governmental unit. Such interfund, quasi-external transactions are accounted for as revenues of the providing fund and expenses or expenditures of the receiving fund, as if they involved outside parties. Such interfund transactions generally constitute the principal source of revenues of internal service funds because those funds are established to serve user funds within the governmental unit.

Internal Service Fund Considerations

13.28 GAAP require internal service funds to operate on a cost reimbursement approach (GASB Cod. sec. 1300.104b(2)), which implies breakeven each year or over several years. Thus, rates should not be established at confiscatory levels that siphon off assets earmarked for other purposes. Likewise, rates should not be set so low as to incur significant losses that result in retained earnings deficits. A pattern of annual operating deficits, particularly if it results in an accumulated retained earnings deficit, indicates that the fund has failed to charge users adequately for the cost of goods or services provided by the internal service fund. Because the intent of these funds is to facilitate cost allocation, the accumulation of resources or deficits over a long term is considered inappropriate.

Public Entity Risk Pools

13.29 GASB Cod. sec. Po20 defines a *public entity risk pool* as a cooperative group of governmental entities joining together to finance an exposure, liability, or risk. A pool may be stand-alone or included as part of a larger governmental entity. All public entity risk pools should account for their activities in an enterprise fund regardless of whether there is a transfer or pooling of risk.

13.30 Several specific disclosures are required for public entity risk pools, and GASB Cod. sec. Po20 requires revenue and claims development information to be included as required supplementary information (RSI). The RSI includes both information in a table format and a reconciliation of claims liabilities by type of contract.

13.31 Pools that do not transfer or pool risk among participants are acting as claims servicers and not insurers. The operating statements of these pools should report claims servicing revenue and administrative costs. Amounts collected or due from pool participants and paid to settle claims should be reported as a net asset or liability on an accrual basis.

Entities Other Than Pools

13.32 Accounting for participation in pools depends on whether the entity transfers risk to the pool or shares its risks with the risks of other pool participants, or whether it enters a pool that simply performs a claims servicing function for the entity. If an entity does not transfer or share its risks through a pool and uses a single fund to account for its risk-financing activities, that fund should be either the general fund or an internal service fund. Auditors should refer to GASB Cod. secs. C50, J50, and Po20 for accounting and financial reporting guidance for capitalization contributions.

13.33 GASB Cod. sec. C50 requires state and local governments other than pools that use risk management internal service funds to meet certain interfund charges guidelines, including when they are permitted to include in their rates a reasonable provision for expected future catastrophe losses. (See also the GASB Staff Document, *Questions and Answers Guide to Implementation of GASB Statement No. 10.*)

Financial Statement Presentation and Disclosure

13.34 Enterprise funds and internal service funds are each combined in the GPFS. The totals of those two fund types are labeled *enterprise* and *internal service* and displayed in separate columns under the heading *proprietary fund types* in the GPFS.

Summary of Significant Accounting Policies

13.35 A summary of significant accounting policies generally discloses revenue recognition practices, asset lives, methods used to determine and record depreciation on assets, allocations of grant receipts to contributed capital pursuant to GASB Cod. sec. G60, and other applicable accounting policies as outlined in GASB Cod. sec. 2300.106.

Segment Information

13.36 GPFS generally contain combined information and, accordingly, the segment information described in GASB Cod. sec. 2500 is disclosed for certain individual enterprise funds of the primary government, including the blended component units. Segment information usually is disclosed in the footnotes. As noted in GASB Cod. sec. 2500.109, the financial reporting entity's financial statements should make those discretely presented component unit disclosures that are essential to fair presentation of the financial reporting entity's GPFS.

Special Considerations—Government-Owned Hospitals and Universities

13.37 Governmental entities frequently operate hospitals and institutions of higher education. As noted in chapter 15, "Special Governmental Units," of this guide, the provisions of the AICPA Audit and Accounting Guide *Health Care Organizations*, and GASB Cod. sec. Co5, generally apply to those activities.

13.38 Judgment is required in determining the proper fund in which to record health care activity. For example, governmental institutions for the long-term care of the elderly, the mentally retarded, or children are often accounted for in the general fund or a special revenue fund rather than as enterprise funds when they are not user-fee supported. Hospitals operated by governments, however, generally are accounted for as an enterprise fund, as provided by GASB Cod. secs. H50 and Ho5, even if indigent care or contractual allowances are significant.

Internal Control and Auditing Considerations

13.39 Audit objectives for proprietary funds are similar to those for business enterprises. However, as in the case with governmental financial statements generally, compliance with laws and regulations is a significant

consideration. Many smaller governmental entities have neither enough people nor adequate internal control over enterprise fund billing, collection, and accounting functions, and, therefore, the auditor may have to place more reliance on substantive testing.

Proprietary Fund Types

13.40 Proprietary funds normally have the same internal control concerns as all other funds of the reporting entity. However, the following areas frequently require special consideration.

13.41 *Cash.* The cash receipts and collection methods for proprietary funds are often different than those for governmental funds. The auditor should obtain an understanding of the internal control and assess control risk in areas such as public transportation fare-box collections, parking meter collections, lottery revenues, and student registrations.

13.42 *Quasi-Autonomous Component Units.* Many enterprise operations are conducted by quasi-autonomous component units operating separately from the sponsoring government. Accordingly, the internal control of enterprise funds frequently will require separate consideration from that of the sponsoring governmental unit.

13.43 *Utility Billings.* Internal control should provide reasonable assurance that customers have meters, that meters are read, that unusual or illogical readings are investigated, and that the aggregate use indicated by the reading of individual meters is reconcilable to the total use for the system.

Audit Procedures

13.44 *Rate-Setting and Billing Procedures.* The auditor should consider any applicable regulatory rate-setting documents and the data supporting compliance with those regulations. The auditor should also determine whether the rates established are billed consistently and whether rate changes are incorporated into the billing system on a timely basis.

13.45 *Contributions and Grants.* The auditor should review grant and contract documents to determine any restrictions or compliance requirements and determine the amount of any noncompliance liability. Noncompliance may require the refund of all or a part of the grant.

Chapter 14

Fiduciary Funds

Introduction

14.01 The fiduciary fund type is used to account for assets held by a governmental unit in a trustee or safekeeping capacity, or as an agent for third-party individuals, private organizations, other governmental units, and/or other funds or component units of the financial reporting entity. Fiduciary funds, as defined in GASB Cod. sec. 1300, include *expendable trust funds*, *nonexpendable trust funds*, *pension trust funds*, *investment trust funds*, and *agency funds*.

Nature of Transactions

14.02 Transactions may differ substantially between fiduciary fund types. Accordingly, each is discussed separately.

Expendable Trust Funds

14.03 Expendable trust funds are used to account for fiduciary relationships in which both the trust principal (corpus) and earnings thereon may be expended for the purposes of the trust. A variety of expendable trust funds are found in practice. IRC sec. 457 deferred compensation plans and escheat property may be reported as expendable trust funds, as provided for in GASB Statement No. 32, *Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans*, and GASB Cod. sec. E70, respectively.

Nonexpendable Trust Funds

14.04 Nonexpendable trust funds are commonly used to account for fiduciary relationships in which the trust principal (corpus) may not be expended but must be kept intact, that is, the capital must be maintained. The earnings are sometimes nonexpendable, but often are expendable. Nonexpendable trust funds are often required, for example, when a state or local government receives gifts or bequests to maintain cemeteries, landmark buildings, or other structures in perpetuity.

Pension Trust Funds

14.05 Pension trust funds are used to account for activities related to public employee retirement systems (PERS), which are administered by the financial reporting entity. Some state and local governmental units manage multiple-employer PERS for component units or other governmental units. The employees of some governmental units are covered by PERS administered by other governmental units; for example, teachers in a particular school district are covered by a state PERS established for the benefit of substantially all teachers employed in the state.

Investment Trust Funds

14.06 Investment trust funds are used by governmental entities that sponsor one or more external investment pools. A separate investment trust

fund must be established by the sponsoring government to report the external portion of each pool. (The external portion of an external investment pool is the portion that belongs to legally separate entities that are not part of the sponsoring government's financial reporting entity.) Also, governmental entities that provide individual investment accounts to other legally separate entities that are not part of the same financial reporting entity should report those investments in one or more separate investment trust funds.

Agency Funds

14.07 Agency funds are used to account for fiduciary relationships involving only custodial or modest management responsibilities. They report assets received for, and disbursed to, other governmental units or private sector organizations or groups. Examples of the use of an agency fund include a local government that collects fines for a state or collects sales taxes levied by another unit of government that are redistributed to such other units of government, student activity funds in school districts, escheat property held for other governments (see paragraphs 16.31 and 16.32), or assets held by courts pending disbursements to beneficiaries. GASB Cod. sec. S40.119 requires the use of an agency fund to account for the special assessment debt service transactions and balances currently due when a government is administering special assessment capital improvement projects, but is not obligated in any manner for the special assessment debt.

14.08 The historical practice of using agency funds to account for payroll withholdings is discouraged because such transactions can be accounted for adequately in originating funds. In the interest of maintaining the fewest number of funds possible, transactions that can be accounted for as liabilities of a specific fund (for example, payroll withholding for general fund employees) may be so recorded.

Accounting and Auditing Considerations

Expendable/Nonexpendable Trust Funds

14.09 Expendable trust funds are accounted for in essentially the same manner as governmental funds. Nonexpendable trust funds are accounted for in essentially the same manner as proprietary funds.

Pension Trust Funds

14.10 Pension trust funds are maintained on the accrual basis of accounting. If a PERS meets the provisions of GASB Cod. sec. 2100, the PERS is included in the governmental entity's financial statements. See also GASB Cod. sec. 2100.119 and .140 concerning the reporting of fiduciary funds and PERS.

14.11 GASB Cod. secs. P20, Pe5, and Pe6 include the authoritative sources of acceptable pension accounting principles. These sections are based on the requirements of the following three GASB statements:

- a. GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*
- b. GASB Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered By Defined Benefit Pension Plans*
- c. GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*

Investment Trust Funds

14.12 Investment trust funds are accounted for in essentially the same manner as proprietary funds. Transactions and balances are reported using the economic resources measurement focus and the accrual basis of accounting.

Agency Funds

14.13 Agency funds are purely custodial (assets equal to liabilities) and, thus, do not report a fund equity balance or measure results of operations. Agency funds use the modified accrual basis of accounting.

Deferred Compensation Plans

14.14 IRC sec. 457 authorizes certain state and local governmental units to provide deferred compensation plans for their employees. GASB Cod. sec. D25 provides accounting and reporting guidance for deferred compensation plans. Investments are generally recorded at fair value. Auditors should refer to GASB Cod. secs. I50 and D25 for detailed guidance on accounting and reporting for IRC sec. 457 plan investments (see also paragraph 14.16).

Financial Statement Presentation and Disclosure

Summary of Significant Accounting Policies

14.15 Significant accounting policies to be disclosed include the basis of accounting for each of the fiduciary fund types, a description of the funds in use, the carrying basis of investments, and an explanation of any reservations of fund balance.

Pension Plan Disclosures

14.16 Pension plan disclosures are covered by GASB Cod. secs. Pe5 and Pe6. For defined benefit pension plans included in the financial statements of an employer, certain six-year historical trend required supplementary information (RSI) is also required to be included in the GPFS following the footnotes, unless it is (a) included in a publicly available, stand-alone plan financial report and (b) the employer includes in its notes to the financial statements information about how to obtain the stand-alone plan financial report.

Investment Trust Funds

14.17 In its financial statements, the sponsoring government should present for each investment trust fund a statement of net assets and a statement of changes in net assets. The difference between the external pool assets and liabilities should be captioned *net assets held in trust for pool participants*. In the combined financial statements, investment trust funds should be presented in the balance sheet with trust and agency funds. A separate statement of changes in net assets should be presented for the combined investment trust funds, although that statement may be presented with similar trust funds, such as pension trust funds.

Agency Fund Presentation

14.18 Agency funds should be accounted for on the modified accrual basis. They are purely custodial (assets equal liabilities) and thus do not involve the measurement of results of operations. Neither revenues nor expenditures are recognized in agency funds. The year's activity is shown in a combined statement of changes in assets and liabilities—all agency funds—that presents

changes in all the assets and liabilities rather than in only cash transactions. At the GPFS level, this statement is not required, but the information may be presented in footnotes.

Deferred Compensation Plan Presentation

14.19 In response to changes made to the provisions of IRC sec. 457 in August 1996,* the GASB issued GASB Statement No. 32. That Statement requires that an IRC sec. 457 plan that meets the criteria in GASB Cod. sec. 1300.104c(1) for inclusion in the fiduciary funds of a government should be reported as an expendable trust fund in the financial statement of that government. Prior to issuance of GASB Statement No. 32, all IRC sec. 457 plans were required to be reported in agency funds. GASB Cod. sec. 1300.104c(1) states that trust and agency funds are used to account for assets held by a governmental unit in a trustee capacity or as an agent for individuals, private organizations, other governmental units, and/or other funds. Many sponsors of IRC sec. 457 plans have little administrative involvement and do not perform the investing functions for these plans. Therefore, in evaluating whether an IRC sec. 457 plan meets the criteria in GASB Cod. sec. 1300.104c(1) for inclusion in the fiduciary funds, governmental entities will need to exercise judgment in determining whether they have fiduciary accountability for IRC sec. 457 plans and whether they hold the assets in a trustee capacity. If it is determined that a plan does not meet the criteria in GASB Cod. sec. 1300.104c(1), GASB Statement No. 32 would not require the IRC sec. 457 plan to be presented in the financial statements of the government. The effective date of GASB Statement No. 32 is for financial statements for periods beginning after December 31, 1998. However, if a government complies with the IRC sec. 457 rule changes in an earlier period, GASB Statement No. 32 must be applied in the financial reporting period in which compliance occurs.

Assertions

14.20 GASB Cod. sec. 1300 requires that the financial reporting applicable to fiduciary funds should parallel those of the governmental funds for expendable trust and agency funds and those of proprietary funds for nonexpendable, investment, and pension trust funds. Therefore, the specific audit objectives should also be parallel.

Internal Control and Auditing Considerations

14.21 The audit objectives of fiduciary funds should parallel those of other funds using the accrual or modified accrual basis of accounting.

14.22 Trust agreements or state and local statutes may impose special compliance requirements. In those circumstances, the auditor should obtain evidence of compliance with those requirements, which could have a direct and material effect on the financial statements. That is particularly important if noncompliance occurs and trust fund assets revert to residuary beneficiaries.

* On August 20, 1996, the provisions of IRC sec. 457 were amended. As a result, a plan will not be treated as an eligible deferred compensation plan unless assets and income of the plan are held in trust for the exclusive benefit of participants and their beneficiaries. This rule change immediately applies to new plans, however, existing plans are not required to establish a trust before January 1, 1999.

Audit Procedures

14.23 The auditor should become familiar with the various compliance and fiduciary responsibilities of the entity, as discussed in the previous paragraph. The principal area of audit concern is the potential for the existence of a liability because of a misuse of assets.

14.24 *PERS Transactions.* PERS are generally comparable to pension plans in the private sector, hence, audit objectives are similar. Audit procedures in governmental pension plans differ little in most areas from those of auditing private pension plans. For audit guidance, the auditor can refer to the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, which discusses those procedures. There are, however, some unique functions, aspects, and activities of PERS that require special attention.

14.25 *PERS Legal Requirements.* The auditor should consider whether investments meet applicable statutory requirements. The requirements are normally set forth in state statutes or local ordinances or resolutions. The Employee Retirement Income Security Act (ERISA) does not apply to state and local governments.

14.26 *Pension Plan Administration.* When auditing the PERS, the auditor should determine who holds the administrative responsibilities of establishing contribution level, authorizing payments, and reporting. Some plans are administered on a day-to-day basis by the sponsoring governmental entity, or by a plan administrator, an investment advisor, a bank trust department, an insurance company, or a combination thereof. The auditor should determine who has fiduciary responsibility for the plan and who is responsible for plan administration.

14.27 *Income Allocation.* Pension assets are sometimes combined with other assets of a governmental unit to enhance the investment return in a pooled investment account. If so, the auditor should consider whether investment income is allocated properly.

14.28 *Actuarial Information.* In evaluating actuarial information, the auditor may consider using the work of an actuary. In that connection, the auditor should consider the guidance of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).^[16] That pronouncement, among other things, requires the auditor to make appropriate tests of data provided to the actuary. If the government does not have current actuarial data, the auditor should consider whether he or she should express a qualified opinion or disclaim an opinion. As part of an audit of PERS pension trust funds or the financial statements of a governmental employer that provides or participates in a pension plan, the auditor should consider sending a request to the actuary to confirm information taken from the actuary's report. Appendix N includes an illustration of a confirmation that could be used by the auditor in such a situation.

14.29 *Participant Eligibility.* The auditor should consider testing the application of participant eligibility rules and statutory requirements, and evaluating whether the rules are followed consistently.

14.30 *Participant Vesting.* Vesting in the plan is subject to statutory requirements. The auditor should test vesting computations for compliance, and proper reporting and disclosure.

^[16] [Deleted.]

14.31 Data Verification. Governments that participate in a pension plan administered by another governmental unit often experience difficulty in obtaining needed pension data. Appendix N includes an illustrative actuary confirmation letter. If the minimum information necessary to apply GASB Cod. secs. P20, Pe5, and Pe6 is not available, the auditor should consider whether it is necessary to express a qualified or adverse opinion.

Part IV
Other Governmental Audit Engagements

Chapter 15

Special Governmental Units

Introduction

15.01 Special governmental units usually provide single special-purpose services, in contrast with general governmental units that provide broad ranges of services. School districts represent the largest number of special governmental units; other special governmental units are usually referred to as authorities, agencies, or special districts. Such units are formed to provide a variety of services and may include the following:

- Airports
- Colleges and universities
- Economic development boards
- Fire protection districts
- Forest preserve districts
- Hospitals
- Housing authorities
- Indian tribes
- Industrial development authorities
- Libraries
- Mosquito abatement districts
- Park districts
- Parking authorities
- Pension plans
- Port authorities
- Public building authorities
- Public health districts
- Risk pools
- River conservancy districts
- Road and bridge authorities
- Sanitation districts
- Soil and water conservation, or management districts
- Transportation authorities
- Utilities
- Water authorities

15.02 Depending on its organizational, reporting, and financial relationships and characteristics, a special governmental unit may be considered to be either a primary government, stand-alone government, or a component unit of a reporting entity. In the last case, the unit may elect or be required to issue separate financial statements. The accounting, financial reporting, and auditing considerations described in the preceding chapters, though applicable to general governmental units, are, in most cases, also applicable to either kind of special governmental unit. This chapter provides additional guidance for situations that the auditor may encounter in auditing special governmental units.

Applicability of Other Audit and Accounting Guides

15.03 A special governmental unit may be subject to the audit guidance provided in other audit and accounting guides. Audit guidance in other guides may apply to the following entities frequently operated by governments:

- Providers of health care services
- Colleges and universities
- Certain nonprofit activities
- Employee benefit plans
- Voluntary health and welfare organizations
- Property and liability insurance companies

Accounting Considerations

General Principles

15.04 In planning the audit of a special governmental unit, the measurement focus of the governmental unit needs to be determined. The scope of activities in which the special governmental unit participates must also be considered.

15.05 GASB Cod. secs. 1100.103 and 1300.104 describe the activities that are generally accounted for in each fund type. If the special governmental unit is involved in several distinguishable activities, and the flow of financial resources is the most appropriate measurement focus, it usually will be appropriate to present the unit's operations by using several funds and following the basis of accounting used by governmental funds. If the focus of the special governmental unit is to measure the costs of operations of the organization using the economic resources measurement focus, the proprietary fund model usually should be followed. However, in practice, it is often difficult to determine whether the proprietary model should be used, so judgment may be required. In some instances, the activities of the special governmental unit will be varied, and certain of its activities should be accounted for using each of the models.

15.06 *Primary or Stand-Alone Governments.* All primary and stand-alone governments should prepare financial statements for use by their governing boards, constituencies, creditors, and others. GASB Cod. sec. 2100 provides criteria to determine whether a unit is a primary or stand-alone government or, instead, a component unit that should be included in the financial statements of a financial reporting entity.

15.07 *Component Units Reporting Separately.* GASB Cod. sec. 2600.128 does not prohibit a component unit of a financial reporting entity from issuing separate financial reports. Separately issued financial reports are often issued, particularly if the financial statements are to be used in official statements for the sale of general obligation bonds, revenue bonds, or other debt of the component unit. The identity of the component unit, the fact that it is a component unit, and its relationship with the primary government should be disclosed in a footnote to the financial statements. The independent auditors' report should also disclose, appropriately, that the entity is a component unit of a financial reporting entity.

15.08 *Joint Ventures.* GASB Cod. sec. J50.102 defines a joint venture as a legal entity or other organization that results from a contractual arrangement and that is owned, operated, or governed by two or more participants as

a separate and specific activity subject to joint control, in which the participants retain (a) an ongoing financial interest, or (b) an ongoing financial responsibility. Ongoing financial interest and ongoing financial responsibility are discussed further in GASB Cod. sec. J50.103 and .104. Examples of joint ventures include, but are not limited to, regional transportation authorities, water treatment plants, solid waste facilities, airports, and libraries.

15.09 GASB Cod. sec. J50 discusses accounting for a joint venture. For financial reporting purposes, there are two types of joint ventures: (a) joint ventures whose participants have equity interests and (b) joint ventures whose participants do not have equity interests. If the government has an equity interest in the joint venture, that equity interest should be reported as an asset of the fund that has the equity interest or reported in the GFAAG.

15.10 Generally, for proprietary funds, an *investment in joint venture* account reported in a proprietary fund should report the participating government's equity interest calculated in accordance with the joint venture agreement. If the joint venture agreement provides for the participating government to share in the operating results of the joint venture, the equity interest should be adjusted for the participant's share of the joint venture's net income or loss, regardless of whether the amount is actually remitted. The equity interest should be reported in the proprietary fund's balance sheet as a single amount, and the fund's share of the joint venture's net income or loss should be reported in its operating statement as a single amount.

15.11 Since the equity interest of a governmental fund in a joint venture generally represents equity primarily in capital assets and otherwise does not meet the definition of a financial resource, it is inappropriate to report the entire *net investment in joint venture* as an asset in a governmental fund. All or a portion of the equity interest should be reported in the GFAAG. The amount that should be reported in the GFAAG is the total equity interest adjusted for any portion of the equity interest that is included in the balance sheet of a governmental fund.

15.12 The measurement focus and basis of accounting used by the joint venture are dependent on the flow of resources that are to be measured by the joint venture, regardless of what fund type the investor in the joint venture is. It may be appropriate, therefore, for a joint venture to use the flow of economic resources measurement focus, even though the investor in the joint venture is a fund that uses the flow of financial resources measurement focus.

Special Governmental Units

15.13 *Hospitals.* Hospitals and other providers of health care services generally should be reported as enterprise funds following GASB Cod. secs. H50 and Ho5, as discussed in chapter 13, "Proprietary Fund Types." See also paragraph 9.13 for a discussion of joint costs and appendix L for a copy of SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, in its entirety.

15.14 *Colleges and Universities.* Colleges and universities should follow either the AICPA college guide model or the governmental model of accounting and financial reporting. (See GASB Cod. sec. Co5.) The notes to separately issued financial statements should disclose the relationship to a financial reporting entity and the accounting policies followed. If the AICPA college guide model is followed, all disclosures normally included in governmental financial statements should be made. In particular, disclosures concerning de-

posits with financial institutions, investments, and repurchase agreements and disclosures regarding public employee retirement systems would be applicable. GASB Cod. sec. 2600 discusses how component units, including colleges and universities, should be presented in the financial statements of a financial reporting entity. See also paragraph 9.13 for a discussion of joint costs and appendix L for a copy of SOP 98-2 in its entirety.

15.15 *School Districts.* School districts are the most frequently encountered special units. In some states, school districts operate as an integral part of a local governmental entity; but in others, school districts are primary governments or stand-alone governments. School districts may or may not have common boundaries with a political subdivision. Regardless of whether school districts are component units of a financial reporting entity, joint ventures of several reporting entities (such as consolidated districts), or meet the definition in GASB Cod. sec. 2100 as separate reporting entities, many school districts prepare separate financial statements in order to accomplish one of the following:

- Support state or federal aid applications.
- Report financial activities to parent, taxpayer, and citizen groups.
- Prepare a financial report for use in an official statement.

15.16 There are several unique aspects of school districts, including the following:

- *Attendance Reporting.* Most school districts receive state aid on the basis of average daily membership (ADM) or average daily attendance (ADA). ADM and ADA data typically are determined at individual schools and reported to a central attendance unit. That unit prepares reports for state aid and, in many cases, for federal aid, such as impact aid. Attention should be directed to attendance reporting because of its importance to overall revenues of the school district. Incorrect attendance reporting can lead to the allocation of too much or too little aid.
- *Student Activity Funds.* Most school districts have cash funds or bank accounts at individual schools under the control of school principals (generally student-generated moneys). Attention should be directed to such funds, which are frequently excluded from the entity's normal accounting records and controls. Student activity funds usually are reported as agency funds of the district.
- *U.S. Department of Education Requirements.* The Department of Education has issued *Financial Accounting for Local and State School Systems*, which suggests a standardized chart of accounts for school districts. Financial reporting standards under, and applications for, federal grants generally require preparation according to the format suggested in that publication. The auditor should be familiar with *Financial Accounting for Local and State School Systems* or state-mandated variations of it.
- *School Lunch Programs.* Most school districts participate in the U.S. Department of Agriculture (USDA) free or price-reduced food programs. The auditor should be familiar with the USDA's regulations for such programs. USDA-donated commodities may also pose accounting and reporting problems; they are often reported as revenue when received and are recognized as an expenditure/expense when consumed.

15.17 State departments of education, the Association of School Business Officials, and the National Association of College and University Business Officers (NACUBO) have issued additional nonauthoritative publications on

school system management, accounting, and financial reporting. Those may be helpful to the auditor and any that may be applicable should be identified and considered in developing the audit program.

15.18 *Housing Authorities.* Housing authorities provide shelter to lower income citizens and generally receive substantial capital and operating grants from the U.S. Department of Housing and Urban Development (HUD). The housing authorities provide the low-income housing by owning and managing housing developments, providing rent subsidies paid directly to the landlords, and/or providing vouchers to participants for rent subsidies that permit them to locate their own housing. Housing authorities also may finance low-interest mortgages for citizens and engage in urban renewal activities. Depending on state statutes or local ordinances, housing authorities generally operate as (a) departments of the sponsoring government, (b) component units of a financial reporting entity, or (c) stand-alone governments. Additionally, some housing authorities operate on a regional basis.

15.19 If the criteria for proprietary funds are met, housing authorities should be reported as enterprise funds. Otherwise, they should be accounted for as governmental funds.

15.20 The auditor should be familiar with the various housing grant programs in undertaking an audit of a public housing authority. Additionally, the auditor should consider confirming directly with HUD loans and other housing development and modernization debt to be assured that accrued interest and grant advances receivable have been recorded properly.

15.21 *Financing Authorities.* Many governmental units have established financing authorities to provide resources for specific capital projects or loans to special interest groups, such as organizations of veterans or farmers. Some financing authorities are established for the benefit of other governmental units or nonprofit organizations, for example, a government-supported hospital financing authority. In some cases, a for-profit business organization is the beneficiary of a financing authority. For example, an economic or industrial development authority that issues revenue bonds, the proceeds of which are used to provide for plant expansion, thereby increases a community's employment level and tax base. In other cases, a financing authority may be created by a governmental unit solely to finance internal capital projects, such as university dormitory construction. As a further example, mortgage financing authorities make low-interest mortgage loans available to citizens.

15.22 Typically, a financing authority issues bonds to obtain funds for the construction of a facility that is then leased to another government or private sector organization. Lease payments received are used to service the bond principal and interest, and the ownership of the facility passes to the lessee when the bonds mature and are retired. In some cases, financing authorities develop a permanent capital base that is used for making loans and, occasionally, grants available to applicants.

15.23 Authorities making loans available to citizens or citizen groups typically service bond principal and interest from loan repayments. Interest income in excess of interest expense typically finances administrative costs.

15.24 Some financing authorities (such as hospitals, economic or industrial development) are created solely to lower the cost of borrowing for private sector entities constructing facilities within the jurisdiction served. Generally, the authority does not become directly involved in either the construction or the repayment of the debt. Debt service is usually administered by a financial institution as trustee. Practice supports that in such cases, the debt and related

capital lease receivable can be reported in the financial statements of the government or disclosed in the notes to the financial statements. Fees charged to the entities benefiting from the debt issuance and administrative expenses of the authority should be reported in the operating statement of the authority. GASB Cod. sec. C65 provides certain disclosure requirements for conduit debt obligations (see paragraph 11.32 for a description of the disclosure requirements).

15.25 Governmental units that create authorities to finance their capital projects usually execute lease contracts between the governmental units and the financing authorities. In accounting and reporting for lease agreements between governmental units and public authorities in the GPFS, first it must be determined whether the public authority is part of the governmental reporting entity for financial reporting purposes. If the authority is part of the financial reporting entity, a further determination needs to be made whether the authority's information is to be "blended" or shown "discretely." (See GASB Cod. sec. 2600.105.) When the authority is blended in the GPFS of the reporting entity, the criteria of FASB Statement No. 13, *Accounting for Leases*, do not apply and the public authority's debt and assets should be reported as a form of the primary government's debt and assets. For example, the leased general fixed assets would be reported in the GFAAG and related debt would be reported in the GLTDAG. The debt service activity of the public authority would be reported as a debt service activity of the primary government, and, if the public authority has a general fund, it would be included as a special revenue fund of the primary government.

15.26 Capital lease arrangements between the primary government and public authorities reported as discretely presented component units (or between those component units) should be treated in the same manner as any other lease agreement of a state or local government. These agreements, therefore, should be considered long-term contracts for accounting and financial reporting purposes and afforded capital lease treatment if they meet the criteria of GASB Cod. sec. L20 and FASB Statement No. 13, *Accounting for Leases*. However, related receivables and payables should not be combined with other amounts due to or from component units, or with capital lease receivables and payables with organizations outside of the reporting entity. To avoid the double counting of assets and liabilities resulting from capital lease arrangements, eliminations may be made in accordance with GASB Cod. sec. 2200.112. For additional guidance on accounting and financial reporting for lease transactions, refer to GASB Cod. sec. L20 and chapter 10, "Capital Expenditures and Related Fund and Account Group Activity," of this guide.

15.27 *Transportation Systems.* Transportation systems may operate either as independent regional authorities, as joint ventures of the participating governments, or as component units of a financial reporting entity. Most transportation systems are accounted for as enterprise funds. (See GASB Cod. sec. 1300.104b(1).)

15.28 Most public transportation systems, because of low rates or low ridership, seek outside contributions to finance facilities, equipment, and operating expenses. Net income, nevertheless, should include charges for depreciation on assets acquired from contributions in the form of capital grants in support of construction as well as those acquired from internal resources. Although depreciation expense on all assets is included in the statement of revenues and expenses to determine the net income or loss resulting from the operation of the system, the amount applicable to assets acquired from capital grants may be closed to the related contributed capital account rather than to retained earnings as in GASB Cod. sec. G60.116.

15.29 Utilities. Utilities generally should be accounted for through proprietary funds following GASB Cod. sec. Ut5. GAAP for utilities are generally those applicable to similar businesses in the private sector, as defined in GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*; the measurement focus is on determination of net income, financial position, and cash flows. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, may offer guidance in preparing GPFS for utilities that provide rate-regulated services and meet certain other criteria.

15.30 Indian Tribes. The federal government considers the various recognized Indian tribes as if they are states. Therefore, Indian tribes are usually accounted for as primary government or stand-alone governments. Financial statements for Indian tribes generally will include all the various fund types found in GPFS for other general-purpose governmental units.

Chapter 16

State Governments*

Introduction

16.01 Although the matters discussed in the previous chapters generally apply to both state and local governments, a number of considerations are unique to state governments. Generally, state governments are large operations, some as large and diverse as the largest private sector entities. Distinguishing aspects of state governments that create special auditing considerations include the following:

- Reporting entity definition
- Independence of external auditors
- Joint audits
- Audits of component units
- Jurisdictional concerns
- Aid to local governments
- Pass-through grant programs
- Medicaid
- Lotteries
- Escheat property

Although these areas may also be of concern in audits of local governments, they are more commonly associated with state governments.

Nature of States

16.02 State governments differ from local governmental units because they have sovereign power. The powers of states are limited by their individual constitutions and the powers granted exclusively to the federal government by the Constitution of the United States and the rights guaranteed to citizens by amendments to that constitution. States can enact, repeal, and modify statutes relating to the conduct of the economic, political, social, and individual activities subject to those limitations. All other governing bodies within the state exist as consequences of general or specific authorizations from the state government and are accorded only those powers provided for in such authorizations. State governments have implicit power, while subordinate governments created by states generally are limited to the powers expressly provided to them by the state or not expressly reserved for the state and, in some cases, not expressly prohibited.

16.03 To meet the varying needs of citizens, states have established a variety of forms of state agencies and departments, regional governments, local governments, and special units of government. The extent and nature of those organizations affect the structure of the state financial reporting entity and, thus, the audit approach.

* GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, establishes accounting and financial reporting standards for nonexchange transactions involving financial or capital resources (for example, most taxes, grants, and private donations). The principal issue addressed in GASB Statement No. 33 is the timing of recognition of nonexchange transactions. It is effective for financial statements for periods beginning after June 15, 2000, with earlier application encouraged. References to the recording of transactions addressed by GASB Statement No. 33 will be modified to conform to the requirements of GASB Statement No. 33 in a future edition of this guide. Paragraphs 8.17 through 8.24 provide a summary adapted from GASB Statement No. 33.

16.04 To address the problems inherent in the variety of organizational structures, most states have established accountability centers, usually under the control of state comptrollers or treasurers. Such accountability centers do not normally maintain accountability for all the component units of the state oversight entities. Rather, such centers are often limited to responsibility for the funds and activities of the states from which appropriations are made to departments and agencies. Other component units (such as public benefit corporations and authorities) in many instances maintain their own accounts and manage their own financial affairs, either with or without direct oversight from the accountability centers.

Accounting Considerations

16.05 All GASB pronouncements are applicable to state government financial statements. Nevertheless, state-mandated accounting and reporting requirements may extend beyond GAAP. Such requirements generally come from statutes, and their existence and specifics should be ascertained and confirmed by discussions with representatives of the states' attorneys general, treasurers, comptrollers, and auditors. For example, certain additional financial summaries may be mandated by state statutes.

Auditing Considerations

16.06 In addition to the issues discussed in the previous chapters, those addressed in the following sections should be considered in conducting audits of state governments.

Reporting Entity Definition

16.07 Determining the state financial reporting entity is often difficult because of the diversity of state component units and the numerous, nearly autonomous, component units, such as public benefit corporations, financially independent entities, and decentralized accounting systems. Even greater complexity may result if component units such as banks, railroads, hospitals, student financial loan programs, colleges, and universities are required to be included in the state financial reporting entity. States also tend to be involved in more joint ventures than local governments. Chapter 2, "The Financial Reporting Entity and Fund Structure," discusses considerations associated with defining the financial reporting entity and the related accounting and reporting under GASB Cod. sec. 2100.

Independence of External Auditors

16.08 While ensuring auditor independence at a local government may be difficult, ensuring independence at the state government level can be a major undertaking. The auditor independence requirements outlined in Rule 101 of the AICPA's Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.01), including Interpretation 101-10 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12), are quite extensive and must be reviewed in detail by all auditors working on a state engagement to determine compliance.

16.09 Nonetheless, the auditor of the primary government is to be independent of the primary government and each component unit. Similarly, the auditor of a material component unit is to be independent of the component unit and the primary government.

Joint Audits

16.10 A joint audit occurs when two or more independent certified public accounting firms or a CPA firm and auditors from a government audit agency perform an audit. The resulting audit opinion is signed by both the government

audit agency and the CPA on joint letterhead. Joint audits are typically performed in two ways. In the first, the CPA and the government audit agency each may be responsible for auditing certain funds or entities (that is, component units) and the audit plans and working papers prepared by each are subject to review by the other. The alternative is to have personnel from the government audit agency and the CPA working together on all segments of the audit.

16.11 Joint audits have many benefits, but also pose some unique problems. One problem that sometimes arises when a joint audit is performed (also present when the entire government audit is performed by the government audit agency) is a change in administration as a result of an election. In some cases, the auditor's last date of field work may fall within the outgoing government auditor's term and, therefore, the date of the auditor's report will be within the term of the outgoing government audit official. However, due to the amount of time required to finalize the financial statements and management letter, the signing of the joint audit report, management letter, and representation letter may not occur until after the incoming government audit official takes office.

16.12 Since the incoming government audit official relies on the staff of the audit agency, whoever is in office when the audit report is completed should sign the report, even though the date of the opinion (last date of field work) may fall within the predecessor's term in office. Also, SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), discusses auditors' responsibilities for obtaining written representations in an audit engagement when current management was not present during the period under audit. In this situation, the auditor should obtain written representations from current management on all periods covered in their report.

16.13 Before entering into an agreement to perform a joint audit, the auditor must be satisfied that the CPA firm or government audit agency is independent and meets the appropriate professional standards. In meeting those standards, the CPA firm or government audit agency must be objective, professionally competent, and its work should have been peer reviewed by a recognized professional organization.

16.14 In some cases, the government auditor may not be licensed to practice public accounting. In those situations, unless the government auditor has made provisions for these situations, the auditor may want to consult the state licensing board as to the potential consequences of jointly signing an audit report with a person who is not licensed to practice public accounting.

Audits of Component Units

16.15 In a joint audit, the audit report is signed jointly and severally by the top official in the audit agency and the CPA firm. Therefore, if certain component units are audited by auditors other than those signing the primary government reports, it should be so noted in the report. Additionally, if one or more component units is audited by the CPA firm or the government audit agency acting separately and not in connection with the joint audit of the primary government, that fact should be noted in the joint auditors' opinion.

Jurisdictional Concerns

16.16 State governments generally consist of three branches: executive, legislative, and judicial. Conflicts often exist among the branches regarding

responsibilities and authority. As a practical matter, the auditor should be aware of such possible conflicts and consider whether the appropriate individuals are included in planning the audit, advised of audit progress, and provided opportunities to respond to draft reports.

16.17 The legislative and judicial branches may maintain their own accounting systems. The auditor should be cognizant of the possibility that numerous accounting systems and different internal controls exist and should determine the extent to which such systems need to be evaluated for their effects, if any, on audit procedures.

Aid to Local Governments

16.18 States provide aid to local governments in the form of shared revenue, such as sales or highway taxes, grants and entitlements such as per capita aid, and school aid based on various formulas. Aid is distributed to local governments in many ways and often is based on a formula or eligibility criteria, or both.

16.19 The auditor should consider whether the formula and eligibility criteria are applied properly and consider the internal control structure surrounding the awarding, monitoring, and payment functions. In addition, the auditor should evaluate the reasonableness of amounts recorded as payable to the local governments under the requirements of the various programs, especially if the local and state governmental units have different fiscal year ends. A number of programs operate on a reimbursement basis, and the state, therefore, will not know the actual amount owed until after year end, when local governments report reimbursable claims. Such amounts, therefore, frequently require management estimates.

16.20 The auditor should determine that the amounts payable to the localities for shared revenues are properly accrued and reported in the financial statements. The auditor should consider reviewing disbursements subsequent to year end to gain assurance that all liabilities have been accrued. Additionally, the auditor should ascertain the existence of state receivables resulting from advance payments made to local governments or disallowed expenditures made by local governments.

Pass-Through Grant Programs

16.21 States often act as pass-through agents for federal funds allotted to states for programs administered by local governments and not-for-profit agencies. Many programs, such as Temporary Assistance for Needy Families (TANF) and education programs are financed in that manner.

16.22 The auditor should consider whether the pass-through grant funds are administered in accordance with the compliance requirements specified by the federal government. Because states generally have a significant degree of accountability (especially for monitoring subrecipients) for pass-through funds, the auditor should consider whether the state has procedures, commensurate with its degree of accountability, to determine that those funds are spent properly by local recipients. If the state is allowed to receive fees for administering the programs, the auditor should determine whether the state received the proper amounts.

16.23 The federal government may disallow expenditures not in accordance with the assistance agreement; therefore, there may be a need to establish

an allowance for refunds. The auditor should ensure that the potential need for an allowance for refunds is addressed by management and that the amounts reported, if any, are reasonable under the circumstances. The auditor also should ascertain whether the proper fund and account classifications of pass-through dollars are used, and whether the state has a liability, or a contingent liability, for not disbursing the funds in accordance with federal requirements. GASB Cod. sec. G60 establishes accounting and financial reporting standards for pass-through grants.

Medicaid

16.24 Medicaid services may be administered by states and/or through local governments on behalf of the states. In either case, health care providers (for example, hospitals, physicians, nursing homes, pharmacies) are required to follow guidelines established by the state. Various methods and formulas are used to reimburse providers (and local governments) for services rendered, including the following:

- Hospitals and nursing homes may be reimbursed for the costs of rendering the services, with costs based on retrospective cost reports filed by the provider.
- Hospitals and other providers may be paid a predetermined (prospective) amount for each service rendered, based on the nature and/or complexity of the services.
- Nonhospital providers may be reimbursed based on the cost of the service (for example, physician office visit, prescription) up to a maximum cost per service.

At times, the state may make payments during the year to providers, particularly hospitals, based on interim reports. Settlements may be made at year end, based on audited cost reports. Those settlements can be either receivables from or payables to the providers.

16.25 In many cases, providers, which may include local governments, may make claims for payments well after year end for services rendered before year end. Because of timing problems, the state may have to estimate the year-end liability to, or receivable from, providers. The auditor should consider whether payables and receivables, and related expenditures and revenues, are properly estimated and recorded at year end. Because these accruals are based on services rendered before year end, the auditor may have to use historical information to ascertain the reasonableness of the receivable or payable.

16.26 The costs of Medicaid are shared between the state and federal governments. Such sharing varies by type of services rendered, which can vary by state. Furthermore, in some states, local governments also share in the costs. The auditor should become familiar with the types of services provided and the cost-sharing arrangements within the state being audited and should ensure that the federal and state (and local, if applicable) shares are reported properly in the financial statements.

Lotteries

16.27 A growing number of states (and some local governments) are using lotteries to supplement revenues. Lottery revenue should be matched with proportionate shares of prize costs and other costs. Accordingly, both revenues

and prize and other costs should be accounted for on an accrual basis, normally in an enterprise fund. To the extent that lottery revenue is legally dedicated for purposes other than prizes, the auditor should determine that applicable legal restrictions are adhered to and the resulting balances presented properly in the financial statements. Lottery prizes may be lump-sum payments, annuities, or both. The auditor should consider whether liabilities have been recorded properly for prizes won but not awarded and amounts to be awarded for games-in-progress at year end.

16.28 Large prizes typically are paid over a period of years. The liability for such prizes is often financed with an annuity purchased from a private insurance company. If the purchased annuity is in the name of the prize winner, no liability or asset is recognized by the government because it has discharged the primary liability. However, consideration should be given to whether a contingent liability exists that should be disclosed in the financial statements. If an annuity in the name of the prize winner is not purchased, the liability and any assets specifically identified to meet that liability should be included in the financial statements of the governmental unit. The auditor should determine whether the liability has been recorded at its present value.

16.29 A number of lottery games provide for a cumulative prize over time and a division of the total prize among many winners. In these situations, policies usually are established that provide for variable payout periods depending on the size of the amount awarded to each individual. For such games-in-progress at year end, it is necessary to record an estimate of the present value of anticipated prizes. The auditor should determine that the estimate of the present value of such anticipated prizes has been calculated and recorded properly.

16.30 Lottery tickets are generally sold in stores and other designated localities throughout the state. Management should estimate the amount of receivables due from the sale locations along with an allowance for doubtful collections from sales agents to whom tickets have been consigned. The auditor should evaluate the reasonableness of those estimates.

Escheat Property

16.31 Because unclaimed property is submitted to the state, state governments are in a unique position. GASB Cod. sec. E70 states that escheat property should generally be reported in either an expendable trust fund or the fund to which the property ultimately escheats (the *ultimate fund*). Escheat property held for another government should be reported in an agency fund or in the fund in which the escheat property is otherwise reported, offset by a liability. Escheat revenue should be reduced and a fund liability reported to the extent that it is probable that escheat property will be reclaimed and paid to claimants. Payments to claimants should reduce the liability.

16.32 If escheat property is initially reported in an expendable trust fund, amounts transferred to the ultimate fund should be reported as an operating transfer. If, as a result of the transfer, the remaining assets of the expendable trust fund are less than the liabilities of that fund, the difference should be reported as an *advance to* in the expendable trust fund and an *advance from* in the ultimate fund. If, however, the escheat assets of the expendable trust fund exceed the liabilities of that fund, the difference should be reported as fund balance.

Food Stamps

16.33 GASB Cod. sec. G60.119 states that state governments should recognize distributions of food stamp benefits as revenue and expenditures in

the general fund or a special revenue fund, whether the state government distributes the benefits directly or through agents and whether the benefits are in paper or electronic form. Expenditures should be recognized when the benefits are distributed to the individual recipients by the state government or its agents; revenue should be recognized at the same time. State governments should report food stamp balances held by them or by their agents at the balance sheet date as an asset offset by deferred revenue. Revenue, expenditures, and balances of food stamps should be measured based on face value. Auditors should refer to GASB Cod. sec. G60.119 for further information.

Part V
Concluding the Audit

Chapter 17

Concluding the Audit

Introduction

17.01 At or near the end of audit field work, the auditor should perform certain additional procedures before issuing his or her report(s). This chapter addresses: (a) written representations from management, (b) disclosures of related-party transactions, (c) going-concern considerations, (d) commitments and contingencies, (e) subsequent events, and (f) analytical procedures.

Written Representations From Management

17.02 SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), requires the auditor to obtain written representations from management as a part of a GAAS audit. It also includes an illustrative management representation letter and an appendix containing additional representations that may be appropriate to be included in a management representation letter in certain circumstances. Such representation should be obtained from those members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management normally include the chief executive officer and chief financial officer or others with equivalent positions in the entity. In a governmental audit, it is often desirable also to obtain the representation letters from other officials (for example, requesting the clerk to the legislative body to represent that the minutes are complete for all meetings held during the period). Further, the auditor should consider obtaining additional representations from management acknowledging the following:

- Management is responsible for compliance with laws, regulations, and provisions of contracts and grant agreements applicable to the entity (including budget laws or ordinances).
- Management is responsible for establishing and maintaining effective internal control over financial reporting.
- Management has identified and disclosed to the auditor all laws, regulations, and provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- Management has identified and disclosed to the auditor violations (or possible violations) of laws, regulations, and provisions of contracts and grant agreements whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

See chapter 5, "Testing and Reporting on Compliance With Laws and Regulations," paragraph 5.25, and chapter 6, "The Budget," paragraphs 6.29 and 6.30 for further discussion of representations from management. SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, discusses additional management representations in a single audit (see appendix M).

17.03 In addition to the representations ordinarily obtained in a GAAS audit, the auditor should consider obtaining representations about the following matters typically relevant in a governmental audit:

- The financial reporting entity's financial statements to be audited
- The inclusion of all component units, and the disclosure of all joint ventures and other related organizations
- The proper classification of funds and account groups
- The proper approval of reserves or designations of fund equities
- Compliance with any tax or debt limits, including any related debt covenants
- Representations relative to GASB-required supplementary information

17.04 SAS No. 85 also states that management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement. The auditor of a governmental unit may encounter difficulty obtaining a representation letter if the responsible administrative officer is an elected official whose term differs from the governmental unit's financial reporting year. For example, a newly elected official may not be willing, or able, to sign representations relating to a period prior to the beginning of his or her term of office. The official may be willing to sign the letter if he or she obtains supporting representations from other key officials who are responsible for financial matters during the period of the audit. SAS No. 85 discusses auditors' responsibilities for obtaining written representations in an audit engagement when current management was not present during the period under audit. In this situation, SAS No. 85 states that auditors should obtain written representations from current management on all periods covered in their report (see chapters 3, "Planning the Audit," paragraph 3.33, and 16, "State Governments," paragraph 16.12).

Disclosure of Related-Party Transactions

17.05 In a governmental audit, related parties include members of the governing board, administrative boards or commissions, administrative officials and their immediate families, and affiliated or related governments that are not included as part of the financial reporting entity. Examples of related-party transactions in a governmental audit include buying supplies or services from a member of the governing body, selling assets owned by the governmental unit to a board member, and establishing a depository relationship with a family member of an administrative official (for example, financial officer).

17.06 The primary accounting and auditing focus for related parties is adequacy of presentation and disclosure in the financial statements. GASB Cod. sec. 2300.107g requires disclosure of related party transactions for all governments. FASB Statement No. 57, *Related Party Disclosures*, which is applicable to proprietary funds, requires the disclosures below. In SAS No. 45, *Omnibus Statement on Auditing Standards*, "Related Parties" (AICPA, *Professional Standards*, vol. 1, AU sec. 334), the section entitled "Disclosure" (AICPA, *Professional Standards*, vol. 1, AU sec. 334.11 and .12), by reference to FASB Statement No. 57, requires the same disclosures.

- a. The nature of the relationship(s) involved
- b. A description of the transactions including transactions to which no amount or nominal amounts were ascribed and such other information deemed necessary to understand the effects of the transactions on the financial statements

- c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
- d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement

To meet the requirements of GASB Cod. sec. 2300.107, these disclosures could also be considered for governmental funds.

Audit Procedures

17.07 To determine the adequacy of presentation and disclosure of related-party transactions, audit procedures are applied throughout the audit. (See AICPA, *Professional Standards*, vol. 1, AU sec. 334.04–.06.) During audit planning, the auditor should identify known related parties and transactions, and update information from previous audits. At the end of the audit, the auditor should consider whether the results of procedures applied during the audit indicated the existence of related-party transactions that require disclosure.

Going Concern Considerations

17.08 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341) provides guidance on the auditor's evaluation of whether there is substantial doubt about the entity's ability to continue as a going concern. Ordinarily, financial statements of a governmental unit are prepared based on the assumption that the reporting entity will continue as a going concern. SAS No. 59 relates going concern to the entity's ability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions.

17.09 Many auditors have held the opinion that governmental units are not subject to the factors that might threaten the future existence of a business enterprise. That is largely attributed to the assumed power of governments to assess and levy taxes (and other charges) sufficient to finance operations and to service long-term and short-term debts. However, the ability to generate revenues, although unlimited by law, can actually be limited by the incomes and resources of taxpayers. Also, in recent years, government have experienced instances in which local taxpayer initiatives have been enacted limiting governmental units' taxing powers. Recent economic events and developments have also raised questions about the ability of certain governments to sustain operations.

17.10 Examples of conditions or events that may indicate substantial doubt about a governmental entity's ability to continue as a going concern are as follows:

- Extremely high estimated liability for incurred-but-not-reported (IBNR) claims in areas not insured
- Accelerating costs on construction and similar long-term projects disproportionate to economic feasibility
- Burdensome pension plan liabilities combined with shrinking populations and diminishing revenues

- Potential for large tax refunds as a result of taxpayers' challenges, reassessments, and large numbers of taxpayers relocating out of the unit's jurisdiction
- Declining tax base
- Unwillingness of senior governments to continue funding programs at existing levels
- Large investment losses
- Bond rating lowered below investment grade
- Major disaster such as earthquake, flood, or fire
- Tax rate at or near the legal limit
- Excessive use of short-term borrowing to reduce cash shortages
- Long-term borrowing to eliminate deficit or to meet current operating needs

17.11 Other factors to be considered include whether federal, state, or other local governments have a legal or moral responsibility to subsidize or otherwise provide financial support to a distressed unit of government. The auditor should consider those areas in evaluating the likelihood of default on debt (for example, revenues less than originally forecasted for repayment of revenue bonds), the inability to meet pension costs or other obligations, the inability of one fund to continue to support the activities or operations of another fund that is incurring large deficits, or the inability to financially support present operating levels.

17.12 If, having considered the guidance in paragraphs 5 through 9 of SAS No. 59 (AICPA, *Professional Standards*, vol. 1, AU sec. 341.05–.09), the auditor concludes that there is substantial doubt about the ability of the governmental unit to continue as a going concern, the auditor should consider the possible effects on the financial statements and the adequacy of the disclosures in the financial statements and include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion in accordance with paragraphs 12 through 16 of SAS No. 59, as amended by SAS No. 77, *Amendments to SAS No. 22, Planning and Supervision, No. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, and No. 62, Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 341.12–.16).

Audit Procedures

17.13 The auditor should evaluate whether conditions or events were noted during the audit up to the date of the auditor's report that indicate there could be substantial doubt about the governmental unit's ability to continue as a going concern. The following are examples of procedures that may identify such conditions and events:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading minutes of meetings of the governing board or any other administrative board with management oversight
- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support

Commitments and Contingencies*

17.14 The auditor should consider whether the existence of any commitments or contingencies require recording or disclosure in the financial statements. Commitments include contractual obligations for a future expenditure/expense, and are usually long-term contractual obligations with suppliers for future purchases at specified prices and sometimes at specified quantities. Disclosure of commitments under unconditional purchase obligations associated with suppliers' financing, whether or not reported in the balance sheet; the terms of the commitments; and provision made for any material losses expected to be sustained should be considered.

17.15 Loss contingencies are existing conditions that may create a legal obligation in the future but that arise from past transactions or events. GASB Cod. sec. C50.110 requires accrual of loss contingencies if under the following circumstances:

- Information available *prior* to issuance of the financial statements indicates that it is *probable* that an asset has been impaired or a liability incurred at the date of the financial statements.
- The amount of the loss can be reasonably estimated.

If no accrual is made for a loss contingency because one or both of the preceding conditions are not met, but there is a *reasonable possibility* that a loss or an additional loss may have been incurred, the financial statements should disclose the nature of the contingency and an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

17.16 For governmental funds, the total amount of the loss contingency that meets the criteria is accrued. The current portion is recorded as a fund liability if the amount normally would be liquidated with expendable available financial resources. Any remaining liability is recorded in the GLTDAG. In proprietary funds, the expense and the liability are recorded in the fund.

* GASB Technical Bulletin (TB) 98-1, *Disclosures about Year 2000 Issues*, and GASB TB 99-1, *Disclosures about Year 2000 Issues—an Amendment of Technical Bulletin 98-1*, provide, among other things, that state and local governments should disclose:

- Any significant amount of resources committed—contracted amounts at the end of the government's reporting period—to address year 2000 issues for computer systems and other electronic equipment.
- A general description of the year 2000 issue as it relates to their organization, including a description of the stages of work in process or completed (four stages are identified in these TBs) as of the end of the government's reporting period to address year 2000 issues for computer systems and other electronic equipment critical to conducting operations.
- That the completion of these stages is not a guarantee that systems and equipment will be year 2000-compliant.

(Readers should consult TB 98-1 and TB 99-1 for a complete description of the required disclosures.) These disclosures can be made either in the notes to the audited financial statements or as required supplementary information.

TB 98-1 is effective for financial statements on which the auditor's report is dated after October 31, 1998. TB 99-1 was effective immediately upon issuance and retroactive application is allowed. The provisions of TB 99-1 terminate for financial statements for periods ending after December 31, 1999, unless mission-critical systems and other equipment are not operating because of the year 2000 issue as of the balance sheet date.

The AICPA has posted nonauthoritative guidance on the AICPA Web site (www.aicpa.org) regarding the auditor's consideration of TB 98-1 (as amended by TB 99-1) disclosures in the notes to the audited financial statements or as required supplementary information. Some entities applied TB 98-1 and issued their audited financial statements prior to the effective date of TB 99-1. The AICPA Web site also provides guidance when an entity wishes to retroactively apply the provisions of TB 99-1, present the required disclosures as supplementary information and reissue their audited financial statements.

17.17 Examples of commitments and contingencies often found in a governmental unit are as follows:

- Sale of assets and agreements to repurchase assets previously sold
- Guarantees or endorsements
- Long-term leases with required fixed payments for several years
- Projects that require annual payments entered into with other governmental units
- Commitments to purchase large quantities of materials or services
- Commitments related to the construction, expansion, or rehabilitation of facilities
- Litigation, claims, and assessments pending, threatened, or unasserted at balance-sheet date
- Proposed or recognized tax refund claims of taxpayers
- Possible claims for disallowed costs or expenditures incurred under a federal financial assistance program
- Contingencies related to risk financing and related insurance activities (see paragraphs 9.14 and 9.15 herein)

Audit Procedures

17.18 Some commitments or contingencies are discovered as a result of procedures applied to specific financial statement elements for other audit objectives. Other procedures that may be employed to identify commitments and contingencies include the following:

- Inquiring of responsible officials about the possibility of unrecorded commitments or contingencies
- Reading the minutes of meetings of the governing body or finance boards
- Reading the contracts, loan agreements, leases, and similar documents
- Reviewing the current and past years' reports from grantor agencies
- Analyzing legal expenses and inspecting invoices from lawyers
- Inquiring of legal counsel

17.19 Occasionally, a government may not retain an inside or outside lawyer and may not have consulted a lawyer during the period about litigation, claims, or assessments. In those cases, the auditor must rely on other audit procedures to disclose the existence of litigation, claims, and assessments, in addition to making inquiries of client officials.

Subsequent Events

17.20 Subsequent events are those that take place after the balance-sheet date but prior to the issuance of the financial statements and auditor's report. (For a discussion, see SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560).) They consist of events or transactions that—

- Provide additional evidence about conditions that existed at the balance-sheet date and affect the estimates inherent in preparing financial statements

- Did not exist at the balance-sheet date but arose subsequent to the date, but nevertheless, are of such a nature that they should be disclosed to prevent the financial statements from being misleading

17.21 Examples of subsequent events in a governmental audit include the settlement of a lawsuit in the subsequent period that was caused by an event taking place in the period being reported on, issuance or defeasance of bonds or other debt instruments, and loss of grant funding or notice of potential disallowances.

Audit Procedures

17.22 Subsequent events may be discovered as a result of audit procedures applied to specific financial statement elements for other audit objectives or through cutoff testing and assessment of asset or liability valuations. Procedures include—

- Reviewing subsequent collections of receivables or payment of expenditures/expenses.
- Inquiring of responsible administrative officials about the current status of material unresolved issues at the balance-sheet date.
- Reading any financial reports prepared since the balance-sheet date.
- Reading minutes of meetings the governing board, or any other administrative board with management oversight, held subsequent to the balance-sheet date.
- Reading subsequent years' budgets (capital and operating).

Analytical Procedures

17.23 Analytical procedures are used as an overall review of the financial information in the final review stage of the audit. The objective of analytical procedures used in the overall review stage is to assist the auditor in assessing the conclusions reached and evaluating the overall financial statement presentation.

17.24 The overall review generally would include reading the financial statements and notes and considering (a) the adequacy of evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit, and (b) unusual or unexpected balances or relationships that were not previously identified. Results of an overall review may indicate that additional evidence may be needed. Paragraphs 4 and 22 of SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329.04 and .22), provides guidance on the use of analytical procedures in the final review stage.

Part VI
Auditor's Reports

Chapter 18

Auditor's Reports on Basic or General-Purpose Financial Statements*

Introduction

18.01 Many governmental units are required by law to publish annual financial reports. An increasing number of such reports contain financial statements that have been audited by independent auditors. The governmental unit management is responsible for the contents of the financial statements, including the notes. The independent auditor's responsibility is to report on whether the financial statements are presented fairly in conformity with GAAP. The type of report the independent auditor issues depends on the contents of the financial statements and on the scope and results of the audit. (See appendix A, "Illustrative Auditor's Reports.")

Levels of Financial Reporting

18.02 GASB Cod. sec. 1900.117 illustrates a financial-reporting *pyramid* (included here as exhibit 18.1, "The Financial Reporting Pyramid"), which characterizes the financial reports of governmental units. The pyramid approach to governmental financial statements has implications for the nature and scope of financial audits.

* GASB Technical Bulletin (TB) 98-1, *Disclosures about Year 2000 Issues*, and GASB TB 99-1, *Disclosures about Year 2000 Issues—an Amendment of Technical Bulletin 98-1*, provide, among other things, that state and local governments should disclose:

- Any significant amount of resources committed—contracted amounts at the end of the government's reporting period—to address year 2000 issues for computer systems and other electronic equipment.
- A general description of the year 2000 issue as it relates to their organization, including a description of the stages of work in process or completed (four stages are identified in these TBs) as of the end of the government's reporting period to address year 2000 issues for computer systems and other electronic equipment critical to conducting operations.
- That the completion of these stages is not a guarantee that systems and equipment will be year 2000-compliant.

(Readers should consult TB 98-1 and TB 99-1 for a complete description of the required disclosures.)

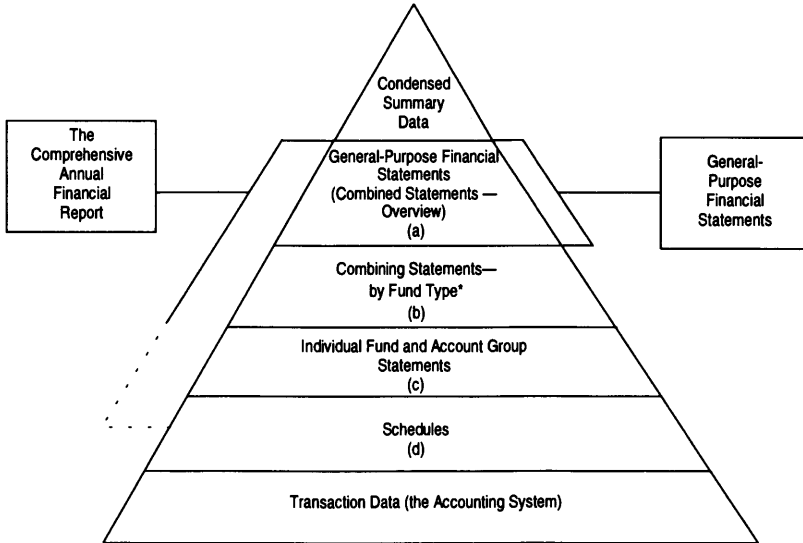
These disclosures can be made either in the notes to the audited financial statements or as required supplementary information.

TB 98-1 is effective for financial statements on which the auditor's report is dated after October 31, 1998. TB 99-1 was effective immediately upon issuance and retroactive application is allowed. The provisions of TB 99-1 terminate for financial statements for periods ending after December 31, 1999, unless mission-critical systems and other equipment are not operating because of the year 2000 issue as of the balance sheet date.

The AICPA has posted nonauthoritative guidance on the AICPA Web site (www.aicpa.org) regarding the auditor's consideration of TB 98-1 (as amended by TB 99-1) disclosures in the notes to the audited financial statements or as required supplementary information. Some entities applied TB 98-1 and issued their audited financial statements prior to the effective date of TB 99-1. The AICPA Web site also provides guidance when an entity wishes to retroactively apply the provisions of TB 99-1, present the required disclosures as supplementary information and reissue their audited financial statements.

Exhibit 18.1

The Financial Reporting Pyramid



— Required
- - - May be necessary

() Refers to "the financial-reporting pyramid" discussion in paragraph 18.03.
Source: GASB Cod. sec. 1900.117.

* GASB Cod. sec. 2600 adds "and for discretely presented component units."

18.03 Exhibit 18.1 illustrates the levels of the pyramid. These levels are discussed in GASB Cod. sec. 1900.118 as follows:

- a. *General-Purpose Financial Statements (Combined Statements—Overview).* These basic financial statements provide a summary overview of the financial position and operating results of the reporting entity. They also serve as an introduction to the more detailed statements and schedules that follow. Separate columns should be used for each fund type and account group of the primary government. The statements should also include one or more separate columns to display the financial position and operating results of the discretely presented component units.
- b. *Combining Statements.*
 - *By Fund Type.* When a primary government (including its blended component units) has more than one fund of a given type (for example, special revenue funds), combining statements for all funds of that type should be presented in a columnar format. The total columns of these combining statements should agree with the amounts presented in the GPFS. (In some instances, disclosure sufficient to meet CAFR reporting objectives may be achieved at this level; in other cases, these statements “link” the GPFS and the individual fund statements.)
 - *For Discretely Presented Component Units.* When a financial reporting entity has more than one discretely presented component unit, the total columns of these combining statements should agree with the amounts presented in the GPFS. (Combining statements are not required if a governmental entity presents each component unit in a separate column in the GPFS.) Statements that present the underlying fund types of an individual discretely presented component unit are also required to be presented if the information is not available in separately issued financial statements of the component unit.
- c. *Individual Fund and Account Group Statements.* These statements present information on the individual funds and account groups of the primary government where (1) a primary government (including its blended component units) has only one fund of a specific type, or (2) detail to assure disclosure sufficient to meet CAFR reporting objectives is not presented in the combining statements. These statements may also be used to present budgetary data and prior-year comparative data for the funds and account groups of the primary government.
- d. *Schedules.* Schedules are used (1) to demonstrate finance-related legal and contractual compliance (for example, where bond indentures require specific data to be presented); (2) to present other information deemed useful (for example, combined and combining schedules that encompass more than one fund or account group, such as a Combined Schedule of Cash Receipts, Disbursements, and Balances—All Funds); and (3) to provide details of data summarized in the financial statements (for example, schedules of revenues, expenditures, transfers).

All four pyramid levels of detail may be required in some circumstances. On the other hand, adequate disclosure may require only one or two levels. Deter-

mination of the appropriate level of detail—and the distinction as to what is presented in a statement as opposed to a schedule—is a matter of professional judgment.

18.04 Combined financial statements in governmental financial reporting are significantly different from those in commercial financial reporting. In the commercial area, combined financial statements generally are aggregated financial statements for two or more business enterprises that do not have a parent-subsidiary relationship. In the governmental area, combined financial statements show the respective fund types and account groups in side-by-side columns. Illustrations of combined financial statements are included in GASB Cod. sec. 2200.901-.906.

18.05 GASB Cod. sec. 1900.109 states that every governmental entity should prepare and publish a CAFR that includes all funds and account groups of the primary government and all discretely presented component units of the reporting entity. The CAFR contains introductory information, schedules necessary to demonstrate compliance with finance-related legal and contractual provisions, and statistical data. The main components of the CAFR are—

- a. The GPFS (See paragraphs 18.08 through 18.10 herein.)
- b. Combining statements for the fund types of the primary government (including its blended component units). Combining statements should also be presented for the discretely presented component units.
- c. Individual fund statements and schedules for the funds of the primary government (including its blended component units).

18.06 The GPFS are designed so that they may be lifted from the CAFR and issued separately. Such statements may be used for inclusion in official statements for securities offerings and for widespread distribution to users that require less detailed information about the governmental entity's finances than that which is contained in the CAFR. (The auditor's responsibilities when associated with financial statements included in official statements are discussed in chapter 19, "Association With Financial Statements Included in Official Statements.")

18.07 As discussed in GASB Cod. sec. 2600, the GPFS and CAFR of a financial reporting entity should include the financial statements of component units. As discussed in chapter 2, "The Financial Reporting Entity and Fund Structure" the auditor should perform procedures to be assured that all of the financial reporting entity's component units are included. The auditor may examine ordinances, interview officials, and make other inquiries to evaluate whether there are component units that should be, but have not been, included in the reporting entity according to the provisions of GASB Cod. sec. 2100. Moreover, the auditor also should determine whether components that have been included have been audited and, if so, refer to SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543) and chapter 3, "Planning the Audit," of this guide for further guidance. If the component units have not been audited, it may be.

Financial Statements

General-Purpose Financial Statements (Combined Statements—Overview)

18.08 GASB Cod. sec. 2200.136 states that the fund type and account group financial information included in the GPFS constitutes "fair presentation

in conformity with generally accepted accounting principles." The following are the GPFS discussed and illustrated in GASB Cod. secs. 2200 and 2450:¹⁷

- a. Combined balance sheet—all fund types, account groups, and discretely presented component units
- b. Combined statement of revenues, expenditures, and changes in fund balances—all governmental fund types and discretely presented component units that use governmental fund accounting
- c. Combined statement of revenues, expenditures, and changes in fund balances—budget and actual—general and special revenue fund types (and similar governmental fund types of the primary government, including blended component units, for which annual budgets have been legally adopted)
- d. Combined statement of revenues, expenses, and changes in retained earnings (or equity)—all proprietary fund types and discretely presented component units that use proprietary fund accounting
- e. Combined statement of cash flows—all proprietary fund types and discretely presented component units that use proprietary fund accounting
- f. Notes to the financial statements
- g. Required supplementary information

Trust fund operations may be reported in items *b*, *d*, and *e* above, as appropriate or separately.

18.09 The combined financial statements listed above should include all disclosures necessary for fair presentation in conformity with GAAP. GASB Cod. sec. 2300 provides guidance on disclosures.

18.10 The GPFS may present total columns for the financial reporting entity as a whole. If a total column is presented, it should be captioned "Memorandum Only" because the total column is not comparable to consolidated financial statements. Any eliminations of interfund balances and transactions should be apparent from the headings in the statements or disclosed in the notes to the financial statements. If a total column for the reporting entity as a whole is presented, a total column for the primary government also should be presented and labeled "Memorandum Only."

18.11 *Budgetary Comparisons as Part of Financial Statements.* GASB Cod. sec. 2400 requires that governmental financial reports include, as the minimum budget-basis presentation, comparisons of the appropriated budgets related to data for the general fund, all special revenue funds, and other governmental fund types (including blended component units) for which annual budgets have been adopted. Appropriated budgets are those adopted by either the legislative or governing board of the oversight unit and/or its related component units for their governmental fund types. Budgetary data for the discretely presented component units are not required to be presented in the reporting entity's combined statement of revenues, expenditures, and changes in fund balance—budget and actual.

18.12 If annual budgets are adopted for some, but not all, funds of a particular governmental fund type, data should be presented only for those funds for which annual budgets have been adopted.

¹⁷ The combined financial statements may also contain financial statements for discretely presented component units that use the Industry Audit Guide *Audits of Colleges and Universities* (New York: AICPA, 1993).

18.13 If the budget is prepared on a basis that differs from GAAP, GASB Cod. sec. 2400.104 requires the actual data to be presented on the budgetary basis in the combined statement of revenues, expenditures, and changes in fund balance—budget and actual, general and special revenue fund types. The nature of the reconciling items between GAAP and the budget basis should be disclosed in the notes to the financial statements as outlined in GASB Cod. sec. 2400.104. Accounting and reporting for encumbrances is a common example of such a reconciling item. Encumbrances outstanding at year-end should not be recognized as expenditures; GASB Cod. sec. 1700.129 generally requires them to be reported as reservations of fund balance or disclosed in the notes. Budgets, however, often treat encumbrances as expenditures. Additional guidance on budget-GAAP differences is provided in GASB Cod. sec. 2400.

18.14 *Legal Program or Project Budgets Exceeding One Year in Length.* Some governmental units control spending for particular programs or projects by adopting legal budgets that include more than one year's expected expenditures. For example, legally authorized budgets for capital projects are often adopted for the multiyear lives of the projects. Such budgets are not required to be presented in the GPFS because they are not annual budgets.

18.15 *Legally Required Proprietary Fund Budgets.* Although GAAP do not require the inclusion of budgetary comparisons for proprietary fund types, neither do they preclude them; some jurisdictions may require such presentations by law. Budgetary comparisons for proprietary funds may be presented as supplementary information or in the GPFS.

Comprehensive Annual Financial Report

18.16 In addition to the combined financial statements, a governmental unit also may issue combining, individual fund, and account group financial statements and supporting schedules, usually in the comprehensive annual financial report. The auditor may report on the combining and individual fund financial statements either by themselves or as supplementary financial information.

Financial Statements of Component Units

18.17 As described in GASB Cod. sec. 2600.128, although the nucleus of a financial reporting entity usually is a primary government, an organization other than a primary government, such as a component unit, may serve as a nucleus for a reporting entity when it issues separate financial statements. The requirements of GASB Statement No. 14, *The Financial Reporting Entity*, should be applied in layers "from the bottom up." That is, each component unit layer should apply the definition and display provisions to its own component unit financial reports.

18.18 As discussed in GASB Cod. sec. 2600, a governmental component unit may issue separate financial statements (GPFS or CAFR) as if it were a primary government. Separately issued financial statements of a component unit should acknowledge that it is a component unit of another government, for example, "Sample County School District, a component unit of Sample County." In addition, the notes to the component unit's financial statements should identify the primary government in whose financial reporting entity the component unit is included and describe the relationship with the primary government. However, financial statements that present only the financial data of the primary government should acknowledge that the financial state-

ments do not include the data of component units necessary for fair presentation in conformity with GAAP. (See Example A.4, "Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit," in appendix A.)

Summary Financial Information

18.19 Some governmental units have issued summarized statements that include, for example, some or all adjustments normally associated with commercial consolidated financial statements. The question of whether such summarized financial statements are useful is under study. Current accounting literature requires combined financial statements for fair presentation in conformity with GAAP and considers summarized financial statements supplementary data.

18.20 GASB Cod. sec. 2700.104 states, in part:

Some governmental units have for many years published highly condensed summary financial data, usually as "popular" reports directed primarily to citizens. . . . More recently, several professional association committees and individuals have undertaken research and experimentation directed toward the design of highly condensed summary financial statements for governmental units. Such research and experimentation is encouraged, but . . . such statements should supplement, rather than supplant, the comprehensive annual financial report (CAFR) and the separately issued general-purpose financial statements (GPFs). Further, the data in such highly condensed summary statements should be reconcilable with the combined, combining and individual fund and account group statements, and the reader of such statements should be referred to the CAFR and/or the separately issued GPFs of the governmental unit.

Governments have begun to issue popular reports, reports to citizens, condensed financial statements and summary reports that collectively are referred to as summary financial information. Summary financial information includes financial data derived from the GPFs, which are presented in some form of financial statement(s) along with accompanying footnotes. It does not include charts and graphs including financial information.

18.21 SAS No. 42, *Reporting on Condensed Financial Statements and Selected Financial Data* (AICPA, *Professional Standards*, vol. 1, AU sec. 552), provides guidance in reporting on condensed financial statements that are derived from audited financial statements of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency. Because a governmental unit is not a public entity as defined under SAS No. 42 with respect to reporting on separately issued summary financial information, the provisions of SAS No. 42 do not apply to governmental units. Accordingly, the following paragraphs provide reporting guidance when an auditor of the GPFs is engaged to report on summary financial information issued by a state or local governmental unit in a document that refers to, but does not include, the GPFs.¹⁸

18.22 Guidance on reporting on condensed financial statements and selected financial data that accompany the GPFs from which they were derived

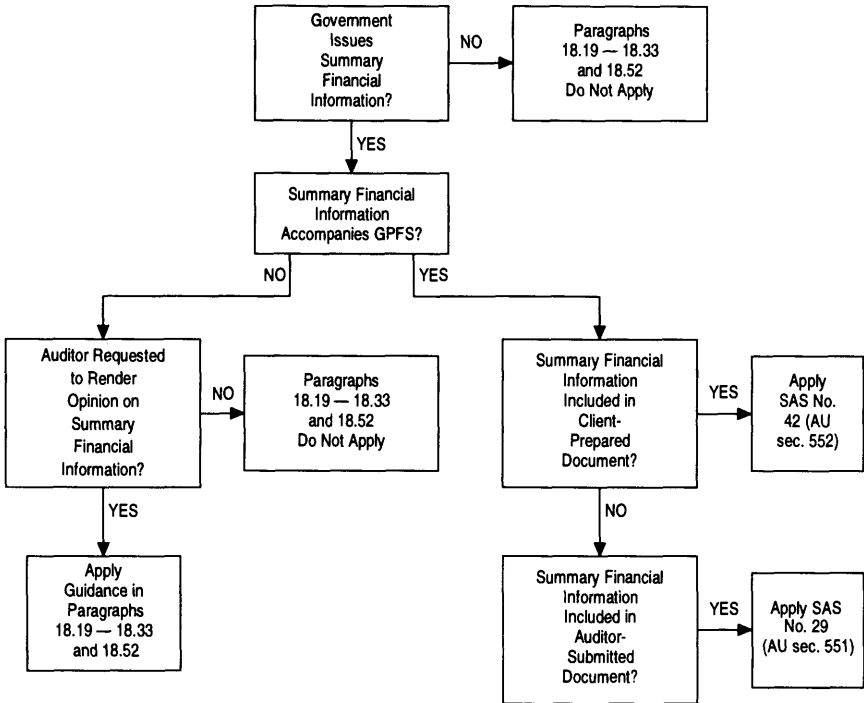
¹⁸ This guidance applies to summary financial information of all state and local governmental entities, including public benefit corporations and authorities, public employee retirement systems, governmental utilities, governmental hospitals and other health care providers, and governmental colleges and universities.

is found in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), and SAS No. 42.¹⁹ The auditor reporting responsibility for the situations described in this paragraph and paragraph 18.21 is presented in the flowchart contained in exhibit 18.2, "Guidance for Reporting on Summary Financial Information." This section does not apply to reporting on portions of a CAFR or GPFS such as a fund, fund type, or account group. The form and content of the data presented and the nature of the document in which the data are presented generally dictate the reporting guidance to be followed.

¹⁹ SAS No. 29 provides guidance on reporting on condensed financial statements or selected financial data that accompany audited financial statements in auditor-submitted documents. SAS No. 42 provides guidance on reporting in a client-prepared document on condensed financial statements or selected financial data derived from audited financial statements included in the client-prepared document.

Exhibit 18.2

Guidance for Reporting on Summary Financial Information



18.23 In the absence of authoritative guidance on format and content, summary financial information often differs from financial statements prepared in accordance with GAAP as to:

- Principles of summarization or aggregation
- Fund structure
- Principles for eliminations
- Reporting budget and actual comparisons
- Inclusion of component units
- Note disclosures

Because of the lack of authoritative guidance on the format and content of summary financial information, the government should exercise discretion in the preparation of the financial information. However, the government should determine whether (a) the summary financial information, including the related notes, is informative of matters that may affect its use, understanding, and interpretation (for example, significant subsequent events, significant contingencies, or restrictions on resources), (b) the summary financial information is prepared on the same measurement focus and basis of accounting as the GPFS, (c) the summary financial information is classified, summarized, and presented in a reasonable manner, and (d) the summary financial information reflects the underlying transactions and events in a manner that presents the summarized data stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in summary financial information.

18.24 When a government issues summary financial information based on the guidance provided in paragraph 18.23, the auditor should follow the guidance in paragraphs 18.26 through 18.32. If a government issues summary financial information that differs from the guidance provided in paragraph 18.23, the auditor should follow the guidance in paragraph 18.33.

18.25 Summary financial information is presented in considerably less detail than that in GPFS, that are intended to present financial position, results of operations, and cash flows in conformity with GAAP. For this reason, it should be read in conjunction with the entity's most recent GPFS that include all the disclosures required by GAAP. Summary financial information is not the primary accountability document of the government. The auditor may only report on summary financial information if the government issues a CAFR or GPFS and the auditor has rendered an opinion on the CAFR or GPFS. In order to render an opinion on the summary financial information, the auditor should have obtained a sufficient audit base through the audit of the GPFS. Where more than one auditor has been involved in rendering an opinion on the GPFS, only the principal auditor should render the opinion on the summary financial information.

18.26 Because summary financial information presents highlights of government activities during the year and does not constitute a fair presentation of financial position, results of operations, and cash flows in conformity with GAAP, an auditor should not report on summary financial information in the same manner as he or she reported on the GPFS from which they are derived. To do so might lead users to assume, erroneously, that the summary financial information is a fair presentation in accordance with GAAP. For the same reason, the summary financial information should be clearly marked as summary financial information.

18.27 Because financial statement users may relate consolidated or condensed financial statements to GAAP, the summary financial information should

not be labeled as condensed financial information or consolidated financial statements.

18.28 The auditor should consider whether the summary of significant accounting principles disclosed in the notes to the summary financial information discloses the method of aggregation used by the government to prepare the summary financial information. The auditor should also consider whether the notes disclose how the method of aggregation materially differs from the principles followed in preparing the GPFs. The explanation of the differences can be achieved through a formal reconciliation or narrative explanation. The availability of the CAFR or separately issued GPFs should also be disclosed in the notes to the summary financial information. In deciding the type of auditor's report to render, the auditor should consider whether the summary financial information is fairly presented in accordance with the method of aggregation described in the notes to the summary financial information. (See paragraph 18.33 for guidance when the summary financial information is prepared on a measurement focus and basis of accounting that differs from the GPFs.)

18.29 The auditor should determine whether the summary financial information has been derived from the GPFs and can be reconciled to the GPFs. If the auditor determines that the summary financial information has not been derived from the GPFs, the auditor should follow the guidance in paragraph 18.33.

18.30 The auditor's report on summary financial information should be based on his or her judgment as to whether (a) the summary financial information including the related notes, is informative of matters that may affect their use, understanding, and interpretation (for example, significant events occurring subsequent to the issuance of the GPFs, significant contingencies, or restrictions on resources), (b) the summary financial information is prepared on the same measurement focus and basis of accounting as the GPFs, (c) the summary financial information is classified, summarized, and presented in a reasonable manner, and (d) the summary financial information reflects the underlying transactions and events in a manner that presents the summarized data stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in summary financial information.

18.31 When the summary financial information and independent auditor's report thereon are presented in a document with other information, the auditor should consider the guidance in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550). SAS No. 8 provides guidance on the auditor's responsibility with respect to information included in a document that is not identified in the audit report. The auditor should be aware of references to other information in the document that would give the perception that the auditor is associated with information other than that specified in the auditor's report on the summary financial information.

18.32 If the auditor concludes that the summary financial information is not fairly stated in all material respects in relation to the GPFs from which it has been derived, the auditor should follow the guidance in paragraph 18.33. If the auditor concludes that the summary financial information is fairly stated in all material respects in relation to the GPFs from which it has been derived, the basic elements of the auditor's report on summary financial information should include the following (see appendix A, example A.17, "Report on Separately Issued Summary Financial Information Prepared in Accordance With the Guidance Provided in Paragraph 18.23."):

- a. A title that includes the word *independent*
- b. A statement that the auditor has audited the GPFS and a reference to the auditor's report on those financial statements, including the date of that report and a description of any modification of the standard report on the GPFS
- c. A statement that the accompanying summary financial information is not a presentation in conformity with GAAP, with a reference to the notes to the summary financial information describing the method of aggregation
- d. An opinion as to whether the information presented in the summary financial information is fairly stated in all material respects in relation to the GPFS from which it has been derived; the issuance of a qualified opinion on the GPFS does not preclude the auditor from issuing a report on the summary financial information as illustrated in appendix A, example A.17
- e. The manual or printed signature of the auditor's firm
- f. The date of the audit report on the summary financial information, which, unless significant subsequent events have occurred, should be the same as the date of the audit report rendered on the GPFS from which it was derived (Should a material event occur subsequent to the date of the audit report on the GPFS, the date on the audit report on the summary financial information should be dual dated for the subsequent event disclosed in the notes to the summary financial information.)

18.33 If a government issues summary financial information in a manner inconsistent with the guidance provided in paragraph 18.23, for example, the measurement focus and basis of accounting differ from that of the GPFS, the auditor should express an adverse opinion on the summary financial information (a different measurement focus and basis of accounting would include changing from a modified accrual basis of accounting to a cash basis, recording depreciation on general fixed assets through the operating statement of a governmental fund type, etc.). In expressing an adverse opinion, the auditor should disclose in a separate explanatory paragraph preceding the opinion paragraph of his or her report (a) all of the substantive reasons for the adverse opinion, and (b) the principal effects of the subject matter of the adverse opinion on the financial positions and results of operations. If the effects are not reasonably determinable, the report should so state. See appendix A, example A.18, "Report on Separately Issued Summary Financial Information Prepared in a Manner Inconsistent With the Guidance Provided in Paragraph 18.23," and paragraphs 67 through 69 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.67–.69) and footnote 6 of SAS No. 42 (AICPA, *Professional Standards*, vol. 1, AU sec. 552.07, footnote 6).

The Independent Auditor's Report

General Concepts

18.34 *Generally Accepted Accounting Principles.* The primary objective of an audit of a governmental unit's financial statements by an independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and, for its proprietary funds and nonexpendable trust funds, cash flows, in conformity with GAAP. As dis-

cussed in chapter 3, "Planning the Audit," the fund types and account groups are important elements of governmental financial statements and audit scope should be established and materiality evaluations should be applied at that level. Further, GPFS must present all applicable fund types and account groups in the governmental combined statement format to conform to GAAP.

18.35 *Principal Auditor and Independence Issues.* There are many situations in which more than one auditor is involved in auditing the components of a reporting entity. A discussion of principal auditor and independence responsibilities in such situations appears in chapter 3.

18.36 *Reporting Other Financial Information Accompanying Basic Financial Statements.* A financial report of a governmental unit may include a wide variety of financial information in addition to the basic financial statements. The types of information typically included are supplemental financial statements, schedules, and statistical data. The manner in which the auditor reports on the additional information depends on the scope of the auditor's examination, the nature of the additional information, and whether the information is included in a client-prepared or auditor-submitted document.

18.37 If the additional information consists of combining or individual fund financial statements and related schedules, the auditor should report on such financial statements and schedules as discussed below. In an auditor-submitted document, the auditor also should report on any other data included in the financial report as discussed in SAS No. 29. If the auditor's report is included in a client-prepared financial report, the auditor should follow the guidance in SAS No. 8 with respect to statistical or other data that the auditor has not audited. (See also, chapter 19, "Association With Financial Statements Included in Official Statements.")

18.38 The statistical section usually contains multiyear comparisons and other financial and nonfinancial information. The independent auditor normally considers the entire statistical section as unaudited and, accordingly, issues a disclaimer of opinion or assures that the statistical section is clearly identified as not covered by the auditor's report. In practice, the latter procedure is usually followed.

18.39 *Prior Year Totals.* The financial statements presented in GASB Cod. sec. 2200.901 include a column for prior-year totals. Footnote 23 to SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508.65, footnote 23) discusses that situation and states that the continuing auditor need not report on such information.

Auditor's Reports

18.40 Many of the forms of reports that may be issued by the independent auditor are described in the following paragraphs.

18.41 *General-Purpose Financial Statements.* If the auditor is engaged to audit the GPFS of a governmental unit that presents only combined financial statements, the auditor should issue a report on the governmental unit's financial position, results of operations, and, if applicable, the cash flows of its proprietary fund types and nonexpendable trust funds. (See appendix A, example A.1, "Unqualified Opinion on General-Purpose Financial Statements.")

18.42 *General-Purpose Financial Statements Submitted Together With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules as Supplementary Data.* If the auditor is engaged to audit the GPFS and also submits combining and individ-

ual fund and account group financial statements as supplementary data, SAS No. 29 applies. Thus, the auditor's report should state whether the combining and individual fund and account group financial statements are stated fairly in all material respects in relation to the GPFS taken as a whole. (See appendix A, example A.2, "Unqualified Opinion on General-Purpose Financial Statements Submitted Together With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules as Supplementary Data.") In addition, the auditor should be satisfied that the combining and individual fund financial statements are suitably titled. As discussed above, the scope of the audit ordinarily includes the application of auditing procedures to individual fund and account group data, and the auditor is in a position to express an opinion on such accompanying information as provided by SAS No. 29.

18.43 If the auditor is engaged to audit the combining and individual fund and account group financial statements in addition to the GPFS, the auditor's opinion addresses each presentation as a primary statement. Ordinarily, in such circumstances, the auditor will need to expand the auditing procedures applied to the combining and individual fund and account group financial statements. (See chapter 3, paragraph 3.12.) If supporting schedules accompany combining and individual fund and account group financial statements, the auditor's report should state whether the information in those schedules is presented fairly in conformity with GAAP in all material respects in relation to the GPFS taken as a whole, or disclaim an opinion on such information. (See appendix A, example A.3, "Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements, Presented Together With Supporting Schedules Reported on as Supplementary Data.")

18.44 *Financial Statements of a Primary Government That Omit the Financial Data of Each Component Unit.* GASB Cod. sec. 2100 establishes criteria for defining the financial reporting entity of a governmental unit. That section describes the legally separate organizations, functions, and activities of government (that is, component units) that should be included in the GPFS of a governmental financial reporting entity. GASB Cod. sec. 2600 recognizes that there may be circumstances in which a primary government may issue separate financial statements that exclude all component units (either blended or discretely presented) considered a part of the financial reporting entity, and requires that the limitations of the financial statements be clearly disclosed. Such separate financial statements for the primary government, in the absence of specific identification by the auditor, could be misinterpreted to be the complete financial statements of the financial reporting entity. Accordingly, when reporting on these separate primary government financial statements, the auditor should—

- Indicate that the financial statements are those of the primary government and not of the financial reporting entity.
- Define the term *primary government*.
- Give an appropriate opinion on the primary government financial statements.
- Opine that the primary government financial statements do not fairly present financial position and results of operations of the financial reporting entity in conformity with GAAP.

See appendix A, example A.4, "Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit."

18.45 A financial reporting entity may include some, but not all, component units in the financial reporting entity financial statements. In that situation, the financial statements should be described as GPFS of the financial reporting entity and the auditor should consider the need to express a qualified or adverse opinion because of a departure from GAAP (see also paragraph 3.12 herein). A qualified or adverse auditor's report should include an explanatory paragraph that describes the omitted component unit(s) and discloses the effects of the omission on the financial statements, if reasonably determinable. (See appendix A, example A.5, "Qualified Opinion on General-Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Financial Reporting Entity.")

18.46 *General-Purpose Financial Statements That Omit a Fund Type, Account Group, or Fund.* If financial statements for fund types or account groups that should be included in the GPFS (such as the general fixed-assets account group or all proprietary funds) are omitted, the auditor is required to express a qualified opinion on the financial statements because of a departure from GAAP. If the financial statements for an individual fund that should be included in the GPFS (such as an individual proprietary fund) are omitted, the auditor should consider the need to express a qualified or an adverse opinion on the financial statements (see also paragraph 3.12 herein). A qualified or adverse auditor's report should include an explanatory paragraph that describes the omitted fund type, account group, or fund and discloses the effects on the financial statements, if reasonably determinable. (See appendix A, example A.6, "Qualified Opinion on General-Purpose Financial Statements That Omit a Fund Type or Account Group," and example A.7, "Qualified Opinion on General-Purpose Financial Statements That Omit a Fund From a Fund-Type.")

18.47 *Individual Fund Financial Statements.* The auditor may be engaged to audit financial statements of only a specified fund or group of funds that are not intended to present fairly financial position, results of operations, or cash flows of either the financial reporting entity or component unit in conformity with GAAP. In such a case, the auditor's report should include a middle paragraph calling attention to the fact that the financial statements are not intended to present financial position and the results of operations of the financial reporting entity or component unit. (See appendix A, example A.8, "Unqualified Opinion on General Fund Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity," and example A.9, "Unqualified Opinion on an Enterprise Fund's Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity.")

18.48 *General-Purpose Financial Statements That Include an Unaudited Organization, Function, or Activity.* Using the criteria established by GASB Cod. sec. 2100, many governmental units' financial reports may include component units that were heretofore reported separately. In certain cases, the financial statements of those units may be unaudited and may result in the auditor's report on the GPFS being qualified or disclaimed, depending on the materiality of the unaudited component unit to the governmental unit's financial statements. (See appendix A, example A.11, "Qualified Opinion on General-Purpose Financial Statements That Include an Unaudited Organization, Function, or Activity.")

18.49 *Financial Statements of a Department Constituting Less Than a Fund.* The auditor may issue an unqualified opinion on the financial statements of a department (or agency) that constitutes less than a fund. The auditor's report should include a middle paragraph that indicates that the statements present information for only a portion of the financial reporting entity. (See appendix A, example A.15, "Unqualified Opinion on Financial Statements of a Department Constituting Less Than a Fund.")

18.50 *Part of the Audit Performed by Another Auditor.* When the auditor is serving as principal auditor and another auditor has audited a material portion of the financial statements, the principal auditor should consider the guidance in chapter 3 and whether to refer to the work of the other auditor. (See appendix A, example A.12(A), "Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of an Organization, Function or Activity by Other Auditors;" A.12(B), "Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements When One Fund or Component Unit Representing Less Than All of a Fund Type Has Been Audited by Other Auditors;" and A.13, "Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of *All* of a Fund Type by Other Auditors.")

18.51 *Summary Financial Information.* The auditor may be engaged to report on summary information issued by a state or local governmental unit in a document that refers to, but does not include, the GPPS. (See appendix A, example A.17, "Report on Separately Issued Summary Financial Information Prepared in Accordance With the Guidance Provided in Paragraph 18.23" and A.18, "Report on Separately Issued Summary Financial Information Prepared in a Manner Inconsistent With the Guidance Provided in Paragraph 18.23.")

Special Reports

18.52 If an independent auditor is engaged to audit financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP, as defined in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), the independent auditor should follow the guidance in SAS No. 62. (See appendix A, example A.14, "Unqualified Opinion on Financial Statements Prepared in Accordance With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles.")

18.53 If the auditor is engaged to audit financial statements presented in conformity with neither GAAP nor an other comprehensive basis of accounting, the auditor should use the standard form of report, modified for the departures from GAAP.

Jointly Signed Reports

18.54 During recent years, a number of governments have required that CPA firms proposing to perform audits of their financial statements provide for minority or smaller firms, or both, to participate in the conduct of the audit. In some cases, those requirements have been met by principal auditors simply by subcontracting a portion of the audit to the minority or smaller firms. In those circumstances, the report on the audit is signed by only the principal auditor in the manner contemplated by SAS No. 1, section 543.

18.55 In other circumstances, the independent auditors participating in the audit have each signed the report in their individual capacities. The profession's standards do not provide for sharing the responsibility for an audit of the financial statements of a single entity by two or more independent auditors. Each individual or firm signing an audit report should be considered to be separately expressing an opinion on the financial statements. Signing the report in an individual capacity is appropriate only if the individual or firm has complied with GAAS and is in a position that justifies being the only signatory of the report.

18.56 A joint endeavor by two firms to conduct an audit could take the form of a legal entity, just as individuals band together to form a firm. In that situation, the report might be signed with the joint venture name. However, before undertaking such an approach, the auditors should consider the implications of ethics rules on the use of fictitious names and state licensing statutes.

Government Auditing Standards Reporting Requirements

18.57 Frequently, governments are required by law, regulation, agreement, contract, or policy to have their financial statements audited in accordance with *Government Auditing Standards*. Chapters 1, 3, 4, and 5 of this guide discuss the various general, fieldwork, and reporting requirements of *Government Auditing Standards*. The remainder of this chapter discusses the additional reporting requirements of *Government Auditing Standards*.

18.58 *Government Auditing Standards* requires that in addition to reporting on the financial statements, the auditor report on (a) compliance with laws, regulations, and provisions of contracts and grant agreements that could have a direct and material effect on the financial statements amounts and (b) the scope of testing of the entity's internal control over financial reporting and on the results of the tests.

18.59 The reporting standards for financial audits in *Government Auditing Standards* contain five additional reporting standards for financial statement audits beyond GAAS:

- a. Auditors should communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit (see paragraph 3.04).
- b. When the report on the financial statement is submitted to comply with a requirement for an audit in accordance with *Government Auditing Standards*, audit reports should state that the audit was made in accordance with generally accepted government auditing standards. This guide recommends the following language be included in the auditor's report to meet this requirement: "we conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States."^{19a} *Government Auditing Standards* also acknowledges that an entity may need a financial statement audit for purposes other than to comply with a requirement calling for an

^{19a} The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

audit in accordance with *Government Auditing Standards*. For example, the entity may need a financial statement audit to issue bonds. In this case, *Government Auditing Standards* permits auditors to issue a separate report on the financial statements conforming only to the requirements of GAAS (see paragraphs 5.11 through 5.14 of *Government Auditing Standards*).

- c. The report on the audit of the financial statements should either (1) describe the scope of the auditor's testing of compliance with laws and regulations and internal control and present the results of those tests or (2) refer to separate reports containing that information (see paragraphs 5.15 through 5.28 of *Government Auditing Standards*). The financial statement reporting recommended in this guide (examples A.16 and A.16(A) of appendix A), illustrates the second option to refer to a separate report on compliance with certain provisions of laws, regulations, contracts, and grants and on internal control over financial reporting. In presenting the results of tests, the auditor should report fraud, illegal acts, other material noncompliance, and reportable conditions in internal control (see paragraphs 4.31 through 4.34 and 5.34 through 5.46). In some circumstances, the auditor should report fraud and illegal acts directly to parties external to the audited entity (see paragraphs 5.37 through 5.39).
- d. If certain information is prohibited from general disclosure (that is, prohibited from general disclosure by federal, state, or local laws or regulations), the audit report should state the nature of the information omitted and the requirement that makes the omission necessary (see paragraphs 5.29 through 5.31 of *Government Auditing Standards*).
- e. Written audit reports are to be submitted by the audit organization to the appropriate officials of the entity and to the appropriate officials of the organizations requiring or arranging for the audit (including external funding organizations), unless legal restrictions prevent it.^{19b} Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection (see paragraphs 5.32 through 5.35 of *Government Auditing Standards*).

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

18.60 This guide recommends that the reporting on the scope of the auditor's testing of compliance and on the internal control over financial reporting based on an audit of the financial statements as required by *Government Auditing Standards* be combined in one report.

18.61 The basic elements of the auditor's standard report on compliance and on the internal control over financial reporting based on an audit of the financial statements in accordance with *Government Auditing Standards* are—

^{19b} Note that when public accountants are engaged, the engaging organization should ensure that the report is distributed appropriately.

- a. A statement that the auditor has audited the financial statements of the entity 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 GAAS and with the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.^{19c}
- c. A statement that as part of obtaining reasonable assurance about whether the entity's financial statements are free of material misstatement, the auditor performed tests of the entity's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.
- d. A statement that providing an opinion on compliance with those provisions was not an objective of the audit and that, accordingly, the auditor does not express such an opinion.
- e. A statement that notes whether the results of tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*^{19d} and, if they are, describes the instances of noncompliance or refers to a separate schedule that summarizes the instances of noncompliance.
- f. If applicable, a statement that certain immaterial instances of noncompliance were communicated to management in a separate letter.^{19e}
- g. A statement that in planning and performing the audit, the auditor considered the entity's internal control over financial reporting in order to determine the auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.
- h. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.
- i. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.
- j. If applicable, a description of the reportable conditions noted or a reference to a separate schedule in which the reportable conditions are described.

^{19c} The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

^{19d} See paragraphs 5.36, 5.40, and 5.41 for a discussion of noncompliance matters that need to be reported under *Government Auditing Standards*.

^{19e} See paragraphs 5.42 and 5.43 for a discussion of reporting other noncompliance matters to top management in accordance with *Government Auditing Standards*.

- k. The definition of a material weakness.
- l. If applicable, a statement that material weaknesses were noted, and if they are, describes the material weaknesses noted or refers to a separate schedule in which they are described. If there are no reportable conditions noted, a statement is made that no material weaknesses were noted.
- m. If applicable, a statement that other matters involving the internal control over financial reporting were communicated to management in a separate letter.^{19f}
- n. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the audit committee, management, and specified legislative or regulatory bodies, and is not intended to be and should not be used by anyone other than these specified parties.^{19g}
- o. The manual or printed signature of the auditor's firm.
- p. The date of the auditor's report.

18.62 Examples of the auditor's report on compliance and on the internal control over financial reporting based on an audit of the financial statements in accordance with *Government Auditing Standards* are included in examples A.16 and A.16(A) of appendix A.

Reporting When Portions of a Governmental Reporting Entity Do Not Have an Audit in Accordance With *Government Auditing Standards*

18.63 Since the implementation of GASB Statement No. 14, *The Financial Reporting Entity*, it is becoming more frequent for governments that are required to have an audit in accordance with *Government Auditing Standards* to include as part of the reporting entity component units that are not required to have such an audit. When this occurs, the auditor should consider modifying his or her report on the financial statements and also the report issued to meet the requirements of *Government Auditing Standards*.

18.64 With regard to the report on the financial statements of the reporting entity, if a material component unit or fund is not required to have an audit in accordance with *Government Auditing Standards* and the report on the financial statements is required to state that the audit was performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of the report on the financial statements to indicate the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows:

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

^{19f} See paragraph 4.33 for a discussion of other internal control matters to be communicated to top management in accordance with *Government Auditing Standards*.

^{19g} Item n. conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports.

Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of [name of fund or component unit] were not audited in accordance with *Government Auditing Standards*. An audit includes examining. . . .

18.65 With regard to the report issued on compliance and on the internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of examples A.16 or A.16(A) of appendix A to indicate the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows:

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

Chapter 19

Association With Financial Statements Included in Official Statements

Introduction

19.01 Debt securities generally are issued on a negotiated sale, a competitive bid basis, or in a private placement. Negotiated offerings are made by the issuer to one or more underwriters who resell the bonds to the public. Competitive bid sales are based on sealed bids submitted by underwriters, investors to the underwriter, or the underwriting group that submitted the best acceptable bid. A private placement occurs for small issues, many times with a local bank. An official statement is generally prepared by the issuer of debt securities with the assistance of financial advisors, bond counsel, and, frequently, the entity's independent accountants.

19.02 Governmental units are exempt from the reporting and registration requirements under the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act). However, the federal antifraud provisions of those acts that relate to the adequacy of disclosures apply to governmental unit security offerings.* The best known of those provisions is section 10b-5 of the 1934 Act, which imposes civil liability for unlawful acts; for example, misrepresentations or omissions of material facts by any person in the offering or sale of securities, including securities issued by governmental units.

19.03 The SEC promulgated Rule 15c2-12 regarding the disclosure responsibilities of underwriters of municipal securities. This rule and the accompanying SEC releases have major implications for the procedures to be followed by issuers in providing information to the market to assist underwriters in meeting their responsibilities. Accordingly, the *Guidelines* reflects the requirements of the rule, especially in the section entitled "Procedural Statements."

19.04 In addition to the SEC Rule and its impact, the general area of disclosure has been the subject of study by various groups. These efforts led to the formulation of additional guidance for use by market participants. Especially noteworthy contributions are those of the National Federation of Municipal Analysts, the National Council of State Housing Agencies, the Municipal Securities Rulemaking Board, and the Public Securities Association.

19.05 An auditor is not required to participate in, or undertake, any procedures with respect to an official statement. In the following situations, however, the auditor should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), for guidance on responsibilities concerning information in the official statement other than the financial statements covered by his or her opinion.

* The Securities and Exchange Commission (SEC) has issued an Interpretation entitled "Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers," that may require municipal bond issuers, in certain circumstances, to disclose matters with respect to year 2000 issues. The Interpretation supersedes the guidance previously set forth in the revised Staff Legal Bulletin No. 5. (This interpretation is available on the SEC Web site www.sec.gov.)

- Manually signing the independent auditor's report included in the offering document.
- Providing written consent to the use of the independent auditor's report in the official statement. (See paragraphs 19.11 and 19.12.)
- Reviewing a draft of the official statement at the client's request.
- Assisting in the preparation of the financial information included in an official statement.
- Issuing an agreed-upon procedures or comfort letter on information included in an official statement.

The guidance in SAS No. 8 provides that the auditor has no obligation to perform any procedures to corroborate other information contained in an official statement. However, the auditor should read the information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. (See paragraph 4 of SAS No. 8 [AICPA, *Professional Standards*, vol. 1, AU sec. 550.04].) Paragraph 5 of SAS No. 8 (AICPA, *Professional Standards*, vol. 1, AU sec. 550.05) further suggests the action an auditor should take if, based on that reading, there is a material misstatement of fact in the other information.

19.06 The following three dates are generally critical in a debt offering of a governmental entity, though the time period between them may vary.

- a. The preliminary official statement (POS) is issued to all prospective buyers of the debt securities.
- b. The official statement (OS) is issued at the time of sale (sometimes referred to as the effective date) and identifies the buyer of the debt and the related actual debt service requirements of the new debt.
- c. The closing date represents the date the transaction is finalized and the cash is transferred from the buyer to the governmental entity.

Letters for Underwriters

19.07 When the accountant is asked to issue a letter consenting to the use of the auditor's report in the official statement, the effective date of the consent can be the POS date or the OS date. When the accountant is asked to prepare a letter for the underwriter, the letter can be as of the POS date or the OS date with updating letters issued as of the OS date (if applicable) and the closing date. The procedures in these letters can be cut off as much as five business days before the date of the letter.

19.08 Underwriting agreements between the governmental issuer and the underwriters may require the auditor to prepare a comfort letter addressed to the underwriters. SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634), defines the term underwriters and gives guidance to accountants in providing letters to *underwriters* in the 1933 Act and to certain other requesting parties. Accountants may provide a comfort letter to a broker-dealer or other financial intermediary acting as principal or agent in offerings of securities issued or backed by governmental entities exempt from registration under the 1933 Act only if the broker-dealer or other intermediary provides the required representation letter. The required elements of the representation letter from a broker-dealer or other financial intermediary are as follows:

- The letter should be addressed to the accountants.
- The letter should contain the following:

This review process, applied to the information relating to the issuer, is (will be) substantially consistent with the due diligence review process that we would perform if this placement of securities (or issuance of securities in an acquisition transaction) were being registered pursuant to the Securities Act of 1933 (the Act). We are knowledgeable with respect to the due diligence review process that would be performed if this placement of securities were being registered pursuant to the Act.

- The letter should be signed by the requesting party.

When a party requesting a comfort letter has provided the accountants with the required representation letter, the accountants should refer in the comfort letter to the requesting party's representations. (See example P in the appendix to SAS No. 72 [AICPA, *Professional Standards*, vol. 1, AU sec. 634.64]. Example P is a typical comfort letter in a non-1933 Act offering, including the required underwriter representations.) If the required representation letter is not provided by the broker-dealer or other intermediary, accountants, who are requested to issue letters in conjunction with securities offerings should follow the guidance in SAS No. 76, *Amendments to SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634). When a comfort letter is requested by a party other than the underwriter, broker-dealer, or other financial intermediary, accountants should not provide that party with a comfort letter or the letter described in paragraph 9 of SAS No. 76. Instead, accountants may provide the party with a report on agreed-upon procedures and should refer to SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622), or Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600), as applicable, for guidance.

19.09 SAS No. 72 requires accountants to perform a review, as discussed in SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), to provide negative assurance in a comfort letter on interim financial information. If the accountant has not performed such a review, he or she is limited to stating procedures performed and findings obtained.

Status as Experts and Use of Financial Statements

19.10 Two interpretations relating to SAS No. 37, *Filings Under Federal Securities Statutes* (AICPA, *Professional Standards*, vol. 1, AU sec. 711), were issued and are found in AICPA, *Professional Standards*, vol. 1, AU sec. 9711.12-.15 and 9711.16-.17. The interpretations addressed the auditor's consent (a) to being named as an expert and (b) to the use of an audit report in an offering document other than one registered under the 1933 Act.

Consenting to Be Named as an Expert in an Offering Document in Connection With Securities Offerings Other Than Those Registered Under the Securities Act of 1933

19.11 This Interpretation (AICPA, *Professional Standards*, vol. 1, AU sec. 9711.12-.15) states that when a client wishes to make reference to the auditor's

role in an offering document in connection with a securities offering that is not registered under the 1933 Act, the caption "Independent Auditors" should be used to title that section of the document; the caption "Experts" should not be used, nor should the auditors be referred to as experts anywhere in the document. The following paragraph should be used to describe the auditor's role.

Independent Auditors

The financial statements as of December 31, 19XX, and for the year then ended, included in this offering circular, have been audited by ABC, independent auditors, as stated in their report(s) appearing herein.

If the client refuses to delete from the offering document the reference to the auditors as experts, the auditor should not permit inclusion of the auditor's report in the offering document.

Consenting to the Use of an Audit Report in an Offering Document Other Than One Registered Under the Securities Act of 1933

19.12 The auditor is not required but may provide a consent in an offering document other than one registered under the 1933 Act. The Interpretation (AICPA, *Professional Standards*, vol. 1, AU sec. 9711.16-.17) provides example language that the auditor may use:

We agree to the inclusion in this offering circular of our report, dated February 5, 19XX, on our audit of the financial statements of [*name of entity*].

Part VII

Audits of Federal Financial Assistance

[Part VII (chapters 20–24) has been superseded by Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*. See appendix M.]

Appendixes

Appendix A

Illustrative Auditor's Reports

A.1 This appendix contains examples illustrating the reports required under GAAS and *Government Auditing Standards*. SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, in appendix M, illustrates the reports required in a single audit.

A.2 Auditors should modify the example reports as necessary for noncompliance and for other matters specified in professional standards such as scope limitations and departures from GAAP.

A.3 In September 1998, the Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), which is effective for reports issued after December 31, 1998. As a result, examples 16 and 16A in this appendix have been changed to reflect the language in SAS No. 87.

A.4 *Government Auditing Standards* states that when the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for a *Government Auditing Standards* audit, the auditor is required to state that the audit was performed in accordance with *Government Auditing Standards*. (Example A.1, footnote 2, provides illustrative wording for this reference to *Government Auditing Standards*.) However, *Government Auditing Standards* do not prohibit auditors from issuing a separate report on the financial statements in accordance with the requirements of GAAS if the financial statement audit is for purposes other than to comply with requirements calling for a *Government Auditing Standards* audit.

A.5 This guide recommends that the reporting on the scope of the auditor's testing of compliance and on the internal control over financial reporting based on an audit of the financial statements as required by *Government Auditing Standards* be combined in one separate report (see examples A.16 and A.16(A)). However, *Government Auditing Standards* gives auditors the option to report on compliance with laws and regulations and internal control over financial reporting in the report on the financial statements. If auditors choose this option, *Government Auditing Standards* requires that the report include an introduction summarizing key findings in the audit of the financial statements and the related compliance and internal control work. Although it may be feasible for auditors to issue such a report, auditors should exercise care to assure that the many unique reporting requirements of both GAAS and *Government Auditing Standards* are met. In addition, in accordance with SAS No. 87 auditors should be aware that if such a single combined report is issued covering both (a) subject matter or presentations that require a restriction on use to specified parties (i.e., reports on compliance with laws and regulations and internal control over financial reporting) and (b) subject matter or presentations that ordinarily do not require such a restriction (i.e., report on the financial statements), the use of such a single combined report should be restricted to the specified parties.

A.6 In many instances, audits performed in accordance with U.S. General Accounting Office, *Government Auditing Standards*, and U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, include a separate restricted-use report (i.e., report

on compliance with laws and regulations and internal control over financial reporting) in a document that also contains a general-use report (i.e., report on the financial statements). The inclusion of a separate restricted-use report in a document that contains a general-use report does not affect the intended use of either report. The restricted-use report remains restricted as to use, and the general-use report continues to be for general use. See SAS No. 87 for further guidance.

A.7 If auditors choose to report on compliance with laws and regulations and internal control over financial reporting in a separate report as is recommended in this guide, the report on the financial statements should refer to the separate report. Example A.1, footnote 3, provides illustrative wording for this reference.

A.8 If the auditor's report on the financial statements contains any departure from the standard report, the reasons for the departure should be described in the auditor's report on compliance and internal control over financial reporting (for example, see footnote 56, example A.16, "Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*," in this appendix).

A.9 The following sample auditor's reports illustrate the types of reports to be issued in selected situations. Chapter 18 of this guide includes discussions of certain of the situations and the resulting reports contained herein. For additional guidance the auditor should refer to SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508). Examples A.17, "Report on Separately Issued Summary Financial Information Prepared in Accordance With the Guidance Provided in Paragraph 18.23," and A.18, "Report on Separately Issued Summary Financial Information Prepared in a Manner Inconsistent With the Guidance Provided in Paragraph 18.23," illustrate reporting on summary financial information as discussed in chapter 18.

Examples Included in Appendix A

Example A.1

Unqualified Opinion on General-Purpose Financial Statements

Example A.2

Unqualified Opinion on General-Purpose Financial Statements Submitted Together With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules as Supplementary Data

Example A.3

Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements, Presented Together With Supporting Schedules Reported on as Supplementary Data

Example A.4

Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit

- Example A.5*** Qualified Opinion on General-Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Financial Reporting Entity
- Example A.6*** Qualified Opinion on General-Purpose Financial Statements That Omit a Fund Type or Account Group
- Example A.7*** Qualified Opinion on General-Purpose Financial Statements That Omit a Fund From a Fund Type
- Example A.8*** Unqualified Opinion on General Fund Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity
- Example A.9*** Unqualified Opinion on an Enterprise Fund's Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity
- Example A.10*** [Deleted as a result of the issuance of SAS No. 79, *Amendment to Statement on Auditing Standards No. 58*, Reports on Audited Financial Statements.]
- Example A.11*** Qualified Opinion on General-Purpose Financial Statements That Include an Unaudited Organization, Function, or Activity
- Example A.12(A)*** Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of an Organization, Function, or Activity by Other Auditors
- Example A.12(B)*** Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements When One Fund or Component Unit Representing Less Than All of a Fund Type Has Been Audited by Other Auditors
- Example A.13*** Unqualified Opinion on General-Purpose Financial Statements With Reference to an Audit of *All* of a Fund Type by Other Auditors

- Example A.14*** Unqualified Opinion on Financial Statements Prepared in Accordance With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles
- Example A.15*** Unqualified Opinion on Financial Statements of a Department Constituting Less Than a Fund
- Example A.16*** Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards (No Reportable Instances of Noncompliance and No Material Weaknesses [No Reportable Conditions Identified])*
- Example A.16(A)*** Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards (Reportable Instances of Noncompliance and Reportable Conditions Identified)*
- Example A.17*** Report on Separately Issued Summary Financial Information Prepared in Accordance With the Guidance Provided in Paragraph 18.23
- Example A.18*** Report on Separately Issued Summary Financial Information Prepared in a Manner Inconsistent With the Guidance Provided in Paragraph 18.23

Example A.1**Unqualified Opinion on General-Purpose Financial Statements¹**Independent Auditor's Report

We have audited the accompanying general-purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.³

[Signature]

[Date]

¹ The financial statements of a component unit should acknowledge that the component unit is a component unit of another government; for example, "We have audited the accompanying general-purpose financial statements of Sample County School District, component unit of Sample County, as of and for the year ended June 30, 19X1." In addition, the notes to the component unit's financial statements should identify the primary government of the financial reporting entity and the component unit's relationship to the primary government. For reporting on the financial statements of a primary government that omit the financial data of each component unit, see the Audit and Accounting Guide *Audits of State and Local Governmental Units*, example A.4, "Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit."

² When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for an audit in accordance with *Government Auditing Standards*, insert the phrase "and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States." The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

³ When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for an audit in accordance with *Government Auditing Standards*, a paragraph similar to the following should be added after the opinion paragraph:

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of the City of the Example's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.

Example A.2

**Unqualified Opinion on General-Purpose Financial Statements
Submitted Together With Combining, Individual Fund, and Account
Group Financial Statements and Supporting Schedules as
Supplementary Data**

Independent Auditor's Report

We have audited the accompanying general-purpose⁴ financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.⁵ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.⁶

The combining and individual fund and account group financial statements and schedules listed in the table of contents are presented for purposes of additional analysis and are not a required part of the general-purpose financial statements of City of Example, Any State. Such information has been subjected to the auditing procedures applied in the audit of the general-purpose financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the general-purpose financial statements taken as a whole.⁷

[Signature]

[Date]

⁴ See footnote 1.

⁵ See footnote 2.

⁶ See footnote 3.

⁷ When reporting on supplementary data, the auditor should consider the effect of any modifications in the report on the general-purpose financial statements. Furthermore, if the report on supplementary information is other than unqualified, this paragraph should be modified. Guidance for reporting in these circumstances is described in paragraphs 9 through 11, 13, and 14 of SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551.09-.11, .13, and .14).

Example A.3**Unqualified Opinion on General-Purpose Financial Statements and Combining, Individual Fund, and Account Group Financial Statements, Presented Together With Supporting Schedules Reported on as Supplementary Data****Independent Auditor's Report**

We have audited the accompanying general-purpose⁸ financial statements and the combining and individual fund and account group financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.⁹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles. Also, in our opinion, the combining and individual fund and account group financial statements referred to above present fairly, in all material respects, the financial position of each of the individual funds and account groups of City of Example, Any State, as of June 30, 19X1, and the results of operations of such funds and the cash flows of individual proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.¹⁰

The accompanying financial information listed as supporting schedules in the table of contents is presented for purposes of additional analysis and is not a required part of the financial statements of City of Example, Any State. Such information has been subjected to the auditing procedures applied in the audit of the general-purpose, combining and individual fund and account group financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements of each of the respective individual funds and account groups taken as a whole.¹¹

[Signature]

[Date]

⁸ See footnote 1.

⁹ See footnote 2.

¹⁰ See footnote 3.

¹¹ See footnote 7.

Example A.4**Report on Primary Government Financial Statements That Omit the
Financial Data of Each Component Unit**Independent Auditor's Report

We have audited the accompanying primary government financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.¹² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

A primary government is a legal entity or body politic and includes all funds, organizations, institutions, agencies, departments, and offices that are not legally separate. Such legally separate entities are referred to as component units. In our opinion, the primary government financial statements present fairly, in all material respects, the financial position of the primary government of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

However, the primary government financial statements, because they do not include the financial data of component units of City of Example, Any State, do not purport to, and do not, present fairly the financial position of the City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.¹³

[Signature]

[Date]

¹² See footnote 2.

¹³ See footnote 3.

Example A.5

**Qualified Opinion on General-Purpose Financial Statements That
Omit One or More, But Not All, Component Units of the Financial
Reporting Entity¹⁴**

Independent Auditor's Report

We have audited the accompanying general-purpose¹⁵ financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.¹⁶ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general-purpose financial statements referred to above do not include financial data of the *[identify the component unit(s) omitted]*, which should be included in order to conform with generally accepted accounting principles. If the omitted component unit(s) had been included,¹⁷ the assets and revenues of the *[identify fund type(s)—for example, special revenue fund type—or component unit column(s)]* would have been increased by \$XXX,XXX and \$XXX,XXX, respectively, there would have been an excess of expenditures over revenues in that fund type *[or component unit(s)]* of \$XXX,XXX for the year, and the *[identify fund type(s) or discretely presented component unit column]* fund balance would have been a deficit of \$XXX,XXX.

¹⁴ There may be circumstances when, based on professional judgment, the auditor may determine that an adverse opinion on the general-purpose financial statements is appropriate. In such a case, a separate explanatory paragraph should state all the substantive reasons for the adverse opinion and the principal effects of those matters. If an adverse opinion is to be rendered, the last two paragraphs of this report should be replaced with the following paragraphs:

The general-purpose financial statements referred to above do not include financial data of the *[identify the component unit(s) omitted]*, which should be included in order to conform with generally accepted accounting principles.

Because of the departure from generally accepted accounting principles identified above, as of June 30, 19X1, the assets and revenues of the *[identify fund type(s)—for example, special revenue fund type—or component unit column(s)]* would have increased by \$XXX,XXX and \$XXX,XXX, respectively, there would have been an excess of expenditures over revenues in the fund type *[or component unit(s)]* for the year of \$XXX,XXX and the *[identify fund type(s) or component unit(s)]* fund balance would have been a deficit of \$XXX,XXX.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the general-purpose financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of City of Example, Any State, as of June 30, 19X1, or the results of its operations or the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended.

¹⁵ See footnote 1.

¹⁶ See footnote 2.

¹⁷ If the amounts applicable to the omitted component unit have not been audited, insert the phrase *based on unaudited information*.

In our opinion, except for the effects on the financial statements of the omission described in the preceding paragraph, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.¹⁸

[Signature]

[Date]

¹⁸ See footnote 3.

Example A.6

**Qualified Opinion on General-Purpose Financial Statements That
Omit a Fund Type or Account Group¹⁹**Independent Auditor's Report

We have audited the accompanying general-purpose²⁰ financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.²¹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general-purpose financial statements referred to above do not include the [identify the fund type (account group) omitted], which should be included in order to conform with generally accepted accounting principles. The omitted fund type²² has assets, liabilities, revenues, and expenditures of \$XXX,XXX, \$XXX,XXX, \$XXX,XXX, and \$XXX,XXX, respectively. [The amount that should be recorded in the (identify account group) is not known.]

In our opinion, except for the effect on the financial statements of the omission described in the preceding paragraph, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.²³

[Signature]

[Date]

¹⁹ See footnote 14.

²⁰ See footnote 1.

²¹ See footnote 2.

²² If the amounts applicable to the omitted fund type or account group have not been audited, insert the phrase *based on unaudited information*.

²³ See footnote 3.

Example A.7

Qualified Opinion on General-Purpose Financial Statements That Omit a Fund From a Fund Type²⁴

Independent Auditor's Report

We have audited the accompanying general-purpose²⁵ financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.²⁶ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general-purpose financial statements referred to above do not include the [*identify the omitted fund*], which should be included in order to conform with generally accepted accounting principles. If the omitted fund²⁷ had been included, the [*identify fund type*] assets, liabilities, revenues, and expenditures would have increased \$XXX,XXX, \$XXX,XXX, \$XXX,XXX, and \$XXX,XXX, respectively.

In our opinion, except for the effect on the general-purpose financial statements of the omission described in the preceding paragraph, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.²⁸

[*Signature*]

[*Date*]

²⁴ See footnote 14.

²⁵ See footnote 1.

²⁶ See footnote 2.

²⁷ If the amounts applicable to the omitted fund have not been audited, insert the phrase *based on unaudited information*.

²⁸ See footnote 3.

Example A.8**Unqualified Opinion on General Fund Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity****Independent Auditor's Report**

We have audited the accompanying financial statements of the general fund of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.²⁹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, the financial statements present only the general fund and are not intended to present fairly the financial position and results of operations of City of Example, Any State, in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the general fund of City of Example, Any State, as of June 30, 19X1, and the results of its operations for the year then ended in conformity with generally accepted accounting principles.³⁰

[Signature]

[Date]

²⁹ See footnote 2.

³⁰ See footnote 3.

Example A.9

**Unqualified Opinion on an Enterprise Fund’s Financial Statements
With an Explanatory Paragraph Calling Attention to the Fact That
the Financial Statements Do Not Represent the Financial Position and
Results of Operations of the Financial Reporting Entity**

Independent Auditor’s Report

We have audited the accompanying financial statements of [*identify enterprise fund*] of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.³¹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, the financial statements present only the [*identify enterprise fund*] and are not intended to present fairly the financial position of City of Example, Any State, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [*identify enterprise fund*] of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows for the year then ended in conformity with generally accepted accounting principles.³²

[*Signature*]

[*Date*]

³¹ See footnote 2.

³² See footnote 3.

Example A.10**Unqualified Opinion on General-Purpose Financial Statements
With an Explanatory Paragraph Calling Attention to a Financial
Reporting Entity's Ability to Meet its Debts as They Come Due^[33-36]**

[Deleted as a result of the issuance of SAS No. 79, *Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508).]

^[33-36] [Deleted.]

Example A.11

**Qualified Opinion on General-Purpose Financial Statements That Include
an Unaudited Organization, Function, or Activity**

Independent Auditor's Report

We have audited the accompanying general-purpose³⁷ financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards.³⁸ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain the audited financial statements supporting the financial activities of the [*identify the organization, function, or activity*], nor were we able to satisfy ourselves as to those financial activities by other auditing procedures. Those financial activities are included in the [*identify fund type, account group, or component unit column(s)*] and represent XX percent and XX percent of the assets and revenues, respectively, of [*identify fund type, account group, or component unit column*].

In our opinion, except for the effects of such adjustment, if any, as might have been determined to be necessary had we been able to obtain the audited financial statements of [*identify the organization, function, or activity*], the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.³⁹

[Signature]

[Date]

³⁷ See footnote 1.

³⁸ See footnote 2.

³⁹ See footnote 3.

Example A.12(A)**Unqualified Opinion on General-Purpose Financial Statements With
Reference to an Audit of an Organization, Function, or Activity by
Other Auditors**Independent Auditor's Report

We have audited the accompanying general-purpose⁴⁰ financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit. We did not audit the financial statements of [*identify organization, function, or activity*], which represent XX percent and XX percent, respectively, of the assets and revenues of the [*identify fund type, account group, or component unit column(s)*]. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for [*identify organization, function, or activity*], is based on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards.⁴¹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.⁴²

[*Signature*]

[*Date*]

⁴⁰ See footnote 1.

⁴¹ See footnote 2.

⁴² See footnote 3.

Example A.12(B)

**Unqualified Opinion on General-Purpose Financial Statements and
Combining, Individual Fund, and Account Group Financial Statements
When One Fund or Component Unit Representing Less Than All of a
Fund Type Has Been Audited by Other Auditors**

Independent Auditor's Report

We have audited the accompanying general-purpose⁴³ financial statements and the combining and individual fund and account group financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit. We did not audit the financial statements of the *[identify fund or component unit]* which statements reflect total assets of \$XXX,XXX as of June 30, 19X1, and total revenues of \$XXX,XXX for the year then ended. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinion on the financial statements, insofar as it relates to the amounts included for the *[identify fund or component unit]* in the *[identify fund type or component unit column(s)]*, is based on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards.⁴⁴ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles. Also, in our opinion, the combining, individual fund, and account group financial statements referred to above (other than the *[identify fund or component unit]*, whose financial statements were audited by other auditors whose report expressed an unqualified opinion) present fairly, in all material respects, the financial position of each of the individual funds and account groups of City of Example, Any State, at June 30, 19X1, and the results of operations of such funds and the cash flows of individual proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.⁴⁵

[Signature]

[Date]

⁴³ See footnote 1.

⁴⁴ See footnote 2.

⁴⁵ See footnote 3.

Example A.13**Unqualified Opinion on General-Purpose Financial Statements With
Reference to an Audit of *All* of a Fund Type by Other Auditors**Independent Auditor's Report

We have audited the accompanying general-purpose⁴⁶ financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit. We did not audit the financial statements of the *[identify fund type]*. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinion on the general-purpose financial statements, insofar as it relates to the amounts included for the *[identify fund type]*, is based on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards.⁴⁷ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.⁴⁸

[Signature]

[Date]

⁴⁶ See footnote 1.

⁴⁷ See footnote 2.

⁴⁸ See footnote 3.

Example A.14

**Unqualified Opinion on Financial Statements Prepared in Accordance
With a Comprehensive Basis of Accounting Other Than Generally
Accepted Accounting Principles**

Independent Auditor's Report

We have audited the accompanying financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.⁴⁹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, City of Example, Any State, prepares its financial statements on the cash basis, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the cash and unencumbered cash balances of City of Example, Any State, as of June 30, 19X1, and the revenues it received and expenditures it paid for the year then ended on the basis of accounting described in Note X.^{50, 51}

[Signature]

[Date]

⁴⁹ See footnote 2.

⁵⁰ If the financial statements are prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject, the opinion paragraph should be followed by a paragraph that restricts the use of the report solely to those within the entity and for filing with the regulatory agency. See paragraphs 5f and 8 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.05f and .08).

⁵¹ See footnote 3.

Example A.15**Unqualified Opinion on Financial Statements of a Department
Constituting Less Than a Fund****Independent Auditor's Report**

We have audited the accompanying financial statements of the Department of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the Department of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.⁵² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note X, the financial statements of the Department of Example, Any State, are intended to present the financial position and results of operations and the cash flows of proprietary fund types of only that portion of the financial reporting entity of the State that is attributable to the transactions of the Department.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Department of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows for the year then ended in conformity with generally accepted accounting principles.⁵³

[Signature]

[Date]

⁵² See footnote 2.

⁵³ See footnote 3.

Example A.16

Report on Compliance and on Internal Control Over Financial Reporting⁵⁴ Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* (No Reportable Instances of Noncompliance and No Material Weaknesses [No Reportable Conditions Identified])⁵⁵

We have audited the financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.⁵⁶ We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,⁵⁷ issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether City of Example's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.^{58, 59}

Internal Control Over Financial Reporting

In planning and performing our audit, we considered City of Example's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not

⁵⁴ See paragraph 4.04 for a description of internal control over financial reporting.

⁵⁵ The auditor should use the portions of examples A.16 and A.16(A) that apply to a specific entity situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of example A.16(A). Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of example A.16(A).

⁵⁶ Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors).

⁵⁷ The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

⁵⁸ See paragraphs 5.18 and 5.19 of *Government Auditing Standards* for the criteria for reporting.

⁵⁹ If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "However, we noted certain immaterial instances of noncompliance, which we have reported to management of City of Example in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with paragraph 5.20 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements 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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.⁶⁰

This report is intended solely for the information and use of the audit committee, management, and [*specify legislative or regulatory body*] and is not intended to be and should not be used by anyone other than these specified parties.⁶¹

[*Signature*]

[*Date*]

⁶⁰ If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "However, we noted other matters involving the internal control over financial reporting, which we have reported to management of City of Example in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

⁶¹ This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports.

Example A.16(A)

Report on Compliance and on Internal Control Over Financial Reporting⁶² Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* (Reportable Instances of Noncompliance and Reportable Conditions Identified)⁶³

We have audited the financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.⁶⁴ We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,⁶⁵ issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether City of Example's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*.⁶⁶

*[Include paragraphs describing the instances of noncompliance noted or refer to a separate schedule that includes such information.]*⁶⁷

Internal Control Over Financial Reporting

In planning and performing our audit, we considered City of Example's internal control over financial reporting 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 over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the City of Example's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

⁶² See footnote 54.

⁶³ See footnote 55.

⁶⁴ See footnote 56.

⁶⁵ See footnote 57.

⁶⁶ See footnote 58.

⁶⁷ If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "We also noted certain immaterial instances of noncompliance, which we have reported to management of City of Example in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with chapter 5, paragraph 5.20, of *Government Auditing Standards*, which indicates that communications to "top" management should be referred to.

[Include paragraphs describing the reportable conditions noted or refer to a separate schedule that includes such information.]

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements 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 over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.^{68, 69}

This report is intended solely for the information and use of the audit committee, management, and *[specify legislative or regulatory body]* and is not intended to be and should not be used by anyone other than these specified parties.⁷⁰

[Signature]

[Date]

⁶⁸ If conditions believed to be material weaknesses are disclosed, the report should identify the material weaknesses that have come to the auditor's attention. The last sentence of this paragraph should be replaced with language such as the following: "However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses." *[Include paragraphs describing the material weaknesses noted or refer to a separate schedule that includes such information.]*

⁶⁹ If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "We also noted other matters involving the internal control over financial reporting, which we have reported to management of City of Example in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

⁷⁰ See footnote 61.

Example A.17

**Report on Separately Issued Summary Financial Information Prepared
in Accordance With the Guidance Provided in Paragraph 18.23**Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the general-purpose financial statements of [*City of Example*] as of and for the year ended June 30, 19XX (not presented herein), and have issued our report thereon dated August 15, 19XX.⁷¹

As explained in Note [x], the accompanying summary financial information of [*City of Example*], as of and for the year ended June 30, 19XX, is not a presentation in conformity with generally accepted accounting principles. In our opinion, however, the accompanying summary financial information is fairly stated, in all material respects, in relation to the general-purpose financial statements from which it has been derived.

[*Signature*]

[*Date*]

⁷¹ Describe any departure from the standard report.

Example A.18**Report on Separately Issued Summary Financial Information Prepared in a Manner Inconsistent With the Guidance Provided in Paragraph 18.23**Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the general-purpose financial statements of [*City of Example*] as of and for the year ended June 30, 19XX (not presented herein), and have issued our report thereon dated August 15, 19XX.⁷²

As explained in Note [x], the accompanying summary financial information of [*City of Example*], as of and for the year ended June 30, 19XX, is not a presentation in conformity with generally accepted accounting principles. Furthermore, the summary financial information has been prepared [*specify reason(s) for adverse report, for example, using a different measurement focus and basis of accounting*]⁷³ from the general-purpose financial statements].

In our opinion, because of the significance of [*specify reason(s) for adverse report, for example, using a different measurement focus and basis of accounting*], the accompanying summary financial information, as of and for the year ended June 30, 19XX, is not fairly stated in relation to the general-purpose financial statements.

[*Signature*]

[*Date*]

⁷² Describe any departure from the standard report

⁷³ A different measurement focus and basis of accounting would include changing from a modified accrual basis of accounting to a cash basis, recording depreciation on general fixed assets through the operating statement of a governmental fund type, etc.

Appendix B*

Internal Control Form— Governmental Units

.01 This section and AAM sections 12,200 and 12,300 contain illustrative internal control forms you might use to document your understanding of internal control sufficient to plan an audit of the general purpose financial statements of a state or local government.¹ The illustrative questions are numbered merely for organizational purposes. The numbers are in no way intended to infer completeness or a preferred sequence. These forms may require modifications to meet the needs, preferences, and circumstances of individual firms and their clients. Whenever you use standardized forms, checklists, or questionnaires, you should recognize that important matters in a particular set of circumstances may not be covered.

Instructions

.02 In every audit, you should obtain an understanding of each of the components of internal control sufficient to plan the audit. These forms should be used as a tool in documenting your understanding of internal control, how internal control is designed, and whether controls have been placed in operation.

.03 This form should be used in conjunction with other forms in the following circumstances:

- *Computer Applications Form—Governmental Units* [AAM section 12,020]. To be used to document your understanding of how the entity uses computers and information technology to process significant accounting information.
- *Financial Reporting Information Systems and Controls Forms—Governmental Units* [AAM section 12,030]. To be used for each significant account and transactions cycle.

.04 These forms are appropriate whenever you plan a primarily substantive approach to the financial statement audit (see paragraph .06 below). That is, their completion generally results in control risk being assessed at or slightly below the maximum for all assertions related to account balances and transactions.²

* Reprinted from the *AICPA Audit and Accounting Manual (AAM)*, section 12,010. New York: American Institute of Certified Public Accountants. The AAM contains an entire section devoted to state and local governments which includes an illustrative internal control form, financial reporting information systems and control forms, a computer applications form, illustrative audit programs, and other materials.

¹ See also AAM section 12,040, *Internal Control Checklist—Federal Awards* (OMB Circular A-133 Single Audits), which can be used to evaluate internal control over compliance requirements for major programs in an audit in accordance with Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

² As discussed at AAM section 12,040, OMB Circular A-133 requires the auditor to plan the testing of internal control over compliance with major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. Therefore, a substantive approach to the single audit is not permitted.

.05 If you plan a lower control risk assessment for certain assertions you are required to—

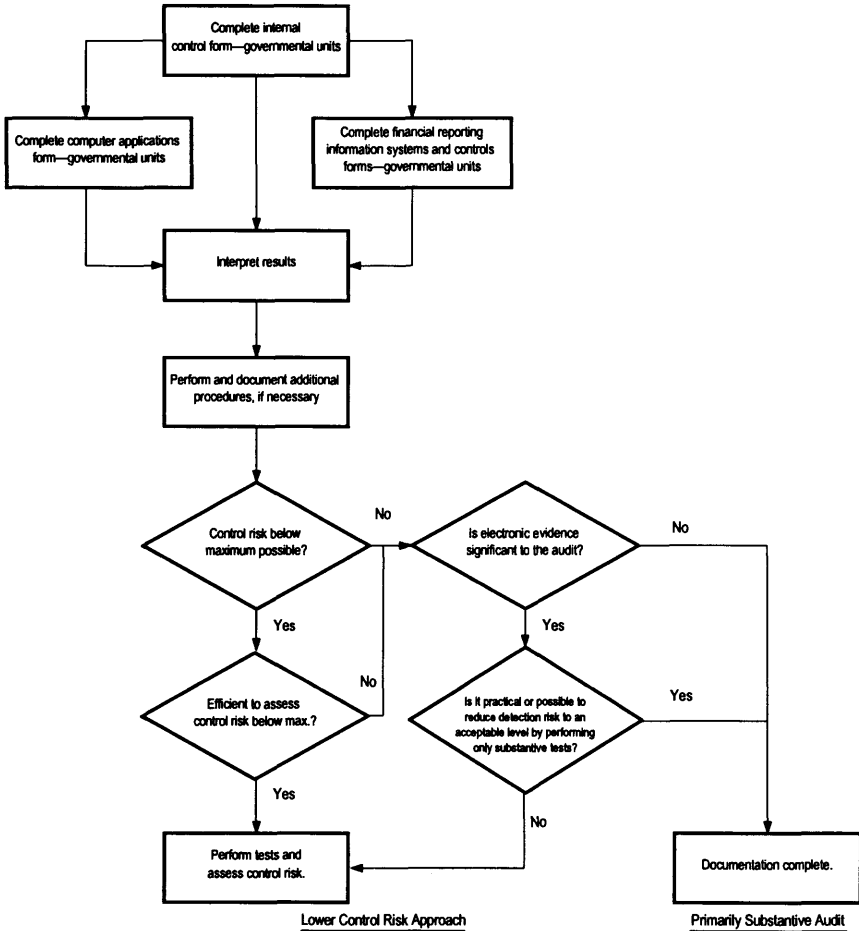
- Identify specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions, and
- Perform tests of controls to evaluate their effectiveness.

The form at AAM Section 12,030 identifies the financial statement assertions to which those specific controls apply.

.06 In situations where a significant amount of audit evidence is transmitted, processed, maintained, or accessed electronically, it generally will be necessary to test the internal control surrounding the electronic evidence (for example, controls over generation, storage, manipulation, and transmission), even if a primarily substantive audit approach is followed. This is because the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness. In those situations the auditor should perform tests of controls to gather evidence to support an assessed level of control risk below the maximum for affected assertions. If the auditor concludes control risk must be assessed at the maximum in such situations or the evidence gathered through tests of controls and substantive tests is insufficient, the auditor should qualify or disclaim an opinion because of the scope limitation. (See AU section 326, *Evidential Matter*.)

.07 These forms are organized to conform to the control components and overall internal control framework described in the Audit Guide *Consideration of Internal Control in a Financial Statement Audit*. This framework is a way for you to consider the impact of internal control on an audit. The classification of any specific control into a particular component should not be your primary concern. Rather, your primary consideration is whether a specific control affects financial statement assertions.

.08 The following flowchart describes how this form can be used in conjunction with the other forms to document your understanding of internal control.



Interpreting the Results

.09 When obtaining an understanding of internal control, you should consider the *collective* effect of the strengths and weaknesses in various control components. Management’s strengths and weaknesses may have a pervasive effect on internal control. For example, strong management oversight may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by management to overstate earnings.

.10 Answers that fall toward the right side of this form (“Strongly Agree” or “Somewhat Agree”) indicate areas of strength in the entity’s internal control. You should consider whether these areas of strength indicate that a control risk assessment below the maximum may be possible for some assertions.

Answers that fall toward the left side of this form (“Strongly Disagree” or “Somewhat Disagree”) indicate areas of weakness in the entity’s internal control. You should assess how these areas of weakness affect the planning of the audit. This assessment should be documented in section V of this form. In making this assessment, you normally focus on—

- The types of material misstatement that could occur as a result of the identified weakness, and
- The risk that those misstatements will occur.

Documenting a Conclusion

.11 After completing this form and the forms at AAM sections 12,020 and 12,030, you should document your conclusion regarding internal control. To perform a primarily substantive audit, you must understand the entity’s internal control sufficiently—

- To assess the risk of material misstatement in assertions related to material financial statement components, and
- To design effective substantive procedures.

.12 If the completion of this form is not sufficient for you to obtain the necessary level of understanding discussed in paragraph .11 above, you should perform and document the results of additional procedures to gain that level of understanding.

.13

I. Document Your Understanding of the Control Environment

In the space provided below, indicate whether you strongly agree, somewhat agree, somewhat disagree, or strongly disagree with the following statements concerning internal control components with a pervasive effect on the entity. Your answers should be based on—

- Your previous experience with the entity.
- Inquiries of appropriate management, supervisory, and staff personnel.
- Inspection of documents and records.
- Observation of the entity’s activities and operations.

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|---|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| A. Control Environment | | | | | |
| <i>Integrity and Ethical Values</i> | | | | | |
| 1. Management has high ethical and behavioral standards. | _____ | _____ | _____ | _____ | _____ |
| 2. The entity is not subject to external forces or pressures that make it vulnerable to errors. | _____ | _____ | _____ | _____ | _____ |
| 3. The public perceives this entity to be ethically managed and adequately controlled. | _____ | _____ | _____ | _____ | _____ |
| 4. Management has communicated (either formally through written policies or informally through its own behavior) the ethical and behavioral standards for the entity and employees have received and understood that message. | _____ | _____ | _____ | _____ | _____ |
| 5. Management reinforces its ethical and behavioral standards. | _____ | _____ | _____ | _____ | _____ |
| 6. Management appropriately deals with signs that problems exist even when the fiscal or political cost of identifying and solving the problem could be high. | _____ | _____ | _____ | _____ | _____ |
| 7. Management has removed or reduced incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. For example, there is generally no— | | | | | |
| a. Pressure to meet unrealistic performance targets. | _____ | _____ | _____ | _____ | _____ |
| b. High performance-dependent rewards. | _____ | _____ | _____ | _____ | _____ |
| c. Upper and lower cutoffs on bonus plans. | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|--|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| 8. Management has provided guidance on the situations and frequency with which intervention of established controls is appropriate. | _____ | _____ | _____ | _____ | _____ |
| 9. Management intervention is documented and explained appropriately. | _____ | _____ | _____ | _____ | _____ |
| <i>Commitment to Competence</i> | | | | | |
| 10. Management has appropriately considered the knowledge, experience, and skill levels necessary to accomplish management, financial reporting, and other essential tasks. | _____ | _____ | _____ | _____ | _____ |
| 11. Employees with management, financial reporting, and other essential responsibilities generally have the knowledge, experience, and skills necessary to accomplish those tasks. | _____ | _____ | _____ | _____ | _____ |
| <i>Governing Board and Audit Committee</i> | | | | | |
| 12. The governing board constructively challenges management's planned decisions. | _____ | _____ | _____ | _____ | _____ |
| 13. Members of the governing board have sufficient knowledge, experience, and time to serve effectively. | _____ | _____ | _____ | _____ | _____ |
| 14. The board members regularly receive the information they need to monitor management's objectives and strategies. | _____ | _____ | _____ | _____ | _____ |
| 15. The audit committee reviews the scope of activities of the internal and external auditors annually. | _____ | _____ | _____ | _____ | _____ |
| 16. The audit committee meets privately with the chief fi- | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|--|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| nancial and/or account- ing officers, internal auditors, and external auditors to discuss the— | | | | | |
| a. Reasonableness of the financial reporting process. | _____ | _____ | _____ | _____ | _____ |
| b. System of internal control. | _____ | _____ | _____ | _____ | _____ |
| c. Significant comments and recommendations. | _____ | _____ | _____ | _____ | _____ |
| d. Management’s performance. | _____ | _____ | _____ | _____ | _____ |
| 17. The board takes steps to ensure an appropriate “tone at the top.” | _____ | _____ | _____ | _____ | _____ |
| 18. The board or committee takes action as a result of its findings. | _____ | _____ | _____ | _____ | _____ |
| <i>Management’s Philosophy and Operating Style</i> | | | | | |
| 19. Management moves carefully, proceeding only after carefully analyzing the risks and potential benefits of its actions. | _____ | _____ | _____ | _____ | _____ |
| 20. Management is generally cautious or conservative in financial reporting matters (such as the selection of accounting policies; application of accounting principles, the development of estimates, and the disclosure of important financial information). | _____ | _____ | _____ | _____ | _____ |
| 21. There is relatively low turnover of key personnel (such as operating, accounting, data processing, and internal audit). | _____ | _____ | _____ | _____ | _____ |
| 22. There is no undue pressure to meet budget or other financial and operating goals. | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|--|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| 23. Management views the accounting and internal audit function as a vehicle for exercising control over the entity's activities. | _____ | _____ | _____ | _____ | _____ |
| 24. Management is concerned about the presence of strong data processing controls. | _____ | _____ | _____ | _____ | _____ |
| 25. Management is committed to reliable financial reporting and the safeguarding of assets. | _____ | _____ | _____ | _____ | _____ |
| 26. Operating personnel review and "sign off" on reported results. | _____ | _____ | _____ | _____ | _____ |
| 27. There is frequent interaction between senior management and operating management, particularly for geographically removed units. | _____ | _____ | _____ | _____ | _____ |
| 28. There is a long-range planning process. | _____ | _____ | _____ | _____ | _____ |
| 29. Goals and objectives for the entity are current and in writing. | _____ | _____ | _____ | _____ | _____ |
| Organizational Structure | | | | | |
| 30. The entity's organization chart is current. | _____ | _____ | _____ | _____ | _____ |
| 31. The entity's organizational structure facilitates the appropriate flow of information relating to its activities. | _____ | _____ | _____ | _____ | _____ |
| 32. Organizational relationships are appropriate. | _____ | _____ | _____ | _____ | _____ |
| 33. Organizational modifications are made when needed due to changing conditions. | _____ | _____ | _____ | _____ | _____ |
| 34. There are sufficient quantities of employees, particularly in management and supervisory capacities. | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|---|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| 35. The organizational structure is appropriate given the entity's program/budget structure. | _____ | _____ | _____ | _____ | _____ |
| <i>Assignment of Authority and Responsibility</i> | | | | | |
| 36. Written job descriptions are current. | _____ | _____ | _____ | _____ | _____ |
| 37. Personnel have copies of their own job descriptions and those of their subordinates. | _____ | _____ | _____ | _____ | _____ |
| 38. Job descriptions are consistent with the organization chart. | _____ | _____ | _____ | _____ | _____ |
| 39. Delegations of authority and responsibility reflect the segregation of duties concept. | _____ | _____ | _____ | _____ | _____ |
| 40. Job descriptions are descriptive of the jobs actually performed. | _____ | _____ | _____ | _____ | _____ |
| 41. Job descriptions contain specific references to control-related responsibilities. | _____ | _____ | _____ | _____ | _____ |
| 42. Members of management fully understand their control responsibilities. | _____ | _____ | _____ | _____ | _____ |
| 43. The entity's principal accounting officer has adequate authority over accounting employees and principal accounting records locations. | _____ | _____ | _____ | _____ | _____ |
| 44. Delegations of authority and responsibility give personnel necessary authority to carry out the functions for which they are responsible. | _____ | _____ | _____ | _____ | _____ |
| 45. There is an adequate definition of key managers' responsibilities and an appropriate understanding of those responsibilities. | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|--|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| 46. Financial reporting responsibilities are clearly defined and reasonably aligned. | _____ | _____ | _____ | _____ | _____ |
| 47. Personnel are given proper resources to carry out their duties. | _____ | _____ | _____ | _____ | _____ |
| 48. Personnel are held accountable for performance and results achieved. | _____ | _____ | _____ | _____ | _____ |
| 49. Managers routinely follow-up on delegations of authority and responsibility to subordinates. | _____ | _____ | _____ | _____ | _____ |
| 50. Personnel understand the entity's objectives and know how their individual actions interrelate and contribute to those objectives. | _____ | _____ | _____ | _____ | _____ |
| <i>Human Resource Policies and Practices</i> | | | | | |
| 51. There are written personnel policies, including for hiring, training, promoting, and compensating employees. | _____ | _____ | _____ | _____ | _____ |
| 52. Payroll and personnel policies governing compensation are in accordance with the requirements of grant agreements. | _____ | _____ | _____ | _____ | _____ |
| 53. The entity generally hires the most qualified people for the job. | _____ | _____ | _____ | _____ | _____ |
| 54. Hiring and recruiting practices emphasize educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior (including background checks for prior actions or activities considered to be unacceptable by the entity). | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|--|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| 55. Recruiting practices include formal, in-depth employment interviews. | _____ | _____ | _____ | _____ | _____ |
| 56. Policies regarding conflicts of interest and code of conduct are established, documented, and distributed. | _____ | _____ | _____ | _____ | _____ |
| 57. New employees receive orientation training, which includes information about the entity's history, culture, and operating style. | _____ | _____ | _____ | _____ | _____ |
| 58. There are accurate and up-to-date performance standards. | _____ | _____ | _____ | _____ | _____ |
| 59. The entity's performance standards are consistent with its operating plan. | _____ | _____ | _____ | _____ | _____ |
| 60. Management performance standards include provisions for maintaining adequate internal control. | _____ | _____ | _____ | _____ | _____ |
| 61. Employees are made aware of their responsibilities and expectations of them. | _____ | _____ | _____ | _____ | _____ |
| 62. The entity provides training opportunities, and employees are well-trained. | _____ | _____ | _____ | _____ | _____ |
| 63. There are adequate employee retention and promotion criteria, and related information gathering techniques, related to compliance with the code of conduct or other behavioral guidelines. | _____ | _____ | _____ | _____ | _____ |
| 64. There are periodic performance appraisals of all employees. | _____ | _____ | _____ | _____ | _____ |
| 65. Promotions and rotation of personnel are based on periodic performance appraisals. | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|--|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| 66. Methods of compensation, including bonuses, are designed to motivate personnel and reinforce outstanding performance. | _____ | _____ | _____ | _____ | _____ |
| 67. Appropriate remedial action is taken in response to departures from approved controls and violations of the code of conduct. | _____ | _____ | _____ | _____ | _____ |
| 68. Employees are adequately supervised. | _____ | _____ | _____ | _____ | _____ |
| 69. Staffing levels are adequate. | _____ | _____ | _____ | _____ | _____ |
| 70. Turnover is low. | _____ | _____ | _____ | _____ | _____ |
| 71. Employees have the right to communicate with any official of rank higher than their immediate supervisor. | _____ | _____ | _____ | _____ | _____ |

B. Risk Assessment

| | | | | | |
|---|-------|-------|-------|-------|-------|
| 1. Management has a process to identify and analyze risks relating to circumstances such as new laws or regulations that affect the entity and new or re-designed services or activities. | _____ | _____ | _____ | _____ | _____ |
| 2. Special action is taken to ensure new personnel understand their tasks. | _____ | _____ | _____ | _____ | _____ |
| 3. Management appropriately considers the control activities performed by personnel who change jobs or leave the entity. | _____ | _____ | _____ | _____ | _____ |
| 4. Management evaluates the risks relevant to the preparation of financial statements and management takes appropriate steps to manage those risks. | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|--|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| 5. Management assesses how new accounting and information systems will impact entity risks and internal control. | _____ | _____ | _____ | _____ | _____ |
| 6. There are mechanisms to identify and react to changes as a result of new technology integrated into the information system. | _____ | _____ | _____ | _____ | _____ |
| 7. Employees are adequately trained when accounting and information systems are changed or replaced. | _____ | _____ | _____ | _____ | _____ |
| 8. Accounting and information system capabilities are upgraded when the volume of information increases significantly. | _____ | _____ | _____ | _____ | _____ |
| 9. Accounting and data processing personnel are expanded as needed when the volume of information increases significantly. | _____ | _____ | _____ | _____ | _____ |
| 10. Controls exist for approving decisions regarding financing alternatives and accounting principles, practices, and methods. | _____ | _____ | _____ | _____ | _____ |
| 11. The entity has the ability to reasonably forecast operating and financial results. | _____ | _____ | _____ | _____ | _____ |
| C. General Control Activities | | | | | |
| 1. The entity prepares operating and capital budgets and cash flow projections. | _____ | _____ | _____ | _____ | _____ |
| 2. Budgets and projections lend themselves to effective comparison with actual results. | _____ | _____ | _____ | _____ | _____ |
| 3. Significant variances between budgeted or projected amounts and actual results are reviewed and explained. | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|---|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| 4. The entity has adequate written statements and explanations of its accounting controls, including— | | | | | |
| a. A chart of accounts accompanied by explanations of the items to be included in various accounts. | _____ | _____ | _____ | _____ | _____ |
| b. Identification and description of the principal accounting records, recurring standard entries, and requirements for supporting documentation. (For example, this may include information about the general ledger, source journals, subsidiary ledgers, and detail records for each significant class of transactions.) | _____ | _____ | _____ | _____ | _____ |
| c. Expression of the assignment of responsibilities and delegation of authority including identification of the individuals or positions that have authority to approve various types of recurring and non-recurring entries. | _____ | _____ | _____ | _____ | _____ |
| d. Explanations of documentation and approval requirements for various types of recurring and nonrecurring transactions and journal entries. (Documentation requirements, for example, would include the basis and supporting computations required for adjustments and write-offs.) | _____ | _____ | _____ | _____ | _____ |
| e. Instructions for determining an adequate cut- | | | | | |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|---|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| off and closing of accounts for each reporting period. | _____ | _____ | _____ | _____ | _____ |
| 5. Internal control manuals are updated as necessary. | _____ | _____ | _____ | _____ | _____ |
| 6. Internal control manuals are distributed to appropriate personnel. | _____ | _____ | _____ | _____ | _____ |
| 7. There are written procedures to test and implement new systems and modifications to existing systems. | _____ | _____ | _____ | _____ | _____ |
| 8. There is general ledger control over all assets and transactions of all departments of the entity. | _____ | _____ | _____ | _____ | _____ |
| 9. All journal entries are reviewed and supported by adequate descriptions or documentation. | _____ | _____ | _____ | _____ | _____ |
| 10. Controls exist that ensure that only authorized individuals can initiate entries into the accounting system. | _____ | _____ | _____ | _____ | _____ |
| 11. Procedures exist to ensure the orderly and effective accumulation of financial data, including that received from departments and other accounting units. | _____ | _____ | _____ | _____ | _____ |
| 12. Valuation reserves or other account balances based on estimates are reviewed and approved. | _____ | _____ | _____ | _____ | _____ |
| 13. The flow of expenditures or commitments is controlled through the use of an allotment system. | _____ | _____ | _____ | _____ | _____ |
| 14. Measures are implemented to correct internal control weaknesses. | _____ | _____ | _____ | _____ | _____ |
| 15. Appropriate insurance coverage is maintained in amounts required by stat- | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|--|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| utes or entity policy. (Such insurance may include coverage for loss of records and assets as well as fidelity bonding of employees in positions of trust.) | _____ | _____ | _____ | _____ | _____ |
| 16. The entity has adequate safekeeping facilities for custody of the accounting records such as fire-resistant locked cabinets, vaults, physical barriers, separate rooms, limited access to work areas, alarms, and other detection devices. | _____ | _____ | _____ | _____ | _____ |
| 17. The entity has a suitable record retention plan. | _____ | _____ | _____ | _____ | _____ |
| 18. There is adequate segregation of duties among those responsible for authorizing transactions, recording transactions, and maintaining custody of assets. | _____ | _____ | _____ | _____ | _____ |
| 19. Access to the general ledger and related records is restricted to those who are assigned general ledger responsibilities. | _____ | _____ | _____ | _____ | _____ |
| D. Information and Communication | | | | | |
| 1. Management receives the information they need to carry out their responsibilities. | _____ | _____ | _____ | _____ | _____ |
| 2. Information is provided at the right level of detail for different levels of management. | _____ | _____ | _____ | _____ | _____ |
| 3. Plans and budgets are effectively communicated throughout the entity. | _____ | _____ | _____ | _____ | _____ |
| 4. Information is available on a timely basis. | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|---|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| 5. Accounting and financial reporting policies and procedures are current, in writing, consistent with statutory authority, and support internal control. | _____ | _____ | _____ | _____ | _____ |
| 6. All journal entries are adequately explained and supported. | _____ | _____ | _____ | _____ | _____ |
| 7. All journal entries are subject to controls over completeness of processing (such as pre-numbering of journal vouchers and accounting for all numbers used, accumulation of control totals of dollar amounts debited and credited, and standard identification numbers for recurring entries). | _____ | _____ | _____ | _____ | _____ |
| 8. All journal entries include adequate identification of the accounts in which they are to be recorded. | _____ | _____ | _____ | _____ | _____ |
| 9. Controls for closing the accounts for a reporting period are sufficient to ensure that accounts are closed, adjusted, and reviewed on a timely basis. | _____ | _____ | _____ | _____ | _____ |
| 10. Procedures exist to ensure that the financial reporting information system has included all transactions applicable to the reporting period. | _____ | _____ | _____ | _____ | _____ |
| 11. Procedures exist to ensure that financial reports are supported by either underlying account records or other documentation. | _____ | _____ | _____ | _____ | _____ |
| 12. Procedures exist providing reasonable assurances that all data required to be included in reports are properly disclosed. | _____ | _____ | _____ | _____ | _____ |

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|--|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| 13. Procedures exist to permit the recording and review of special entries generated in the process of developing financial statements. | _____ | _____ | _____ | _____ | _____ |
| 14. Reporting controls exist for in-progress and completed construction projects. | _____ | _____ | _____ | _____ | _____ |
| 15. Procedures exist to ensure that financial reports are prepared on a consistent basis. | _____ | _____ | _____ | _____ | _____ |
| 16. Performance and financial reports are reviewed and approved at appropriate levels of management and, if appropriate, by the governing board before public release. | _____ | _____ | _____ | _____ | _____ |
| 17. There are procedures to ensure that all requirements for filing of financial reports are met. | _____ | _____ | _____ | _____ | _____ |
| 18. There are channels of communication for people to report suspected improprieties (for example, an ability to contact someone other than a direct supervisor with anonymity permitted). | _____ | _____ | _____ | _____ | _____ |
| 19. Feedback is provided to personnel who report suspected improprieties and they have immunity from reprisals. | _____ | _____ | _____ | _____ | _____ |
| 20. Management is receptive to reports of suspected improprieties. | _____ | _____ | _____ | _____ | _____ |

E. Monitoring

1. There is timely and appropriate follow-up action by management resulting from external party communications, such as cus-

| | <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|---|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| tomers complaints, notification of errors in billings, and notification of inappropriate behavior by an employee. | _____ | _____ | _____ | _____ | _____ |
| 2. Communications from bankers, regulators, or other outside parties are monitored for items of accounting significance. | _____ | _____ | _____ | _____ | _____ |
| 3. Program evaluations and management reviews are routinely performed. | _____ | _____ | _____ | _____ | _____ |
| 4. Employees are required to "sign off" to evidence the performance of critical control functions. | _____ | _____ | _____ | _____ | _____ |
| 5. Management periodically reviews internal control to ensure that it is appropriate and being enforced. | _____ | _____ | _____ | _____ | _____ |
| 6. Accounting managers and personnel are supervised at all locations. | _____ | _____ | _____ | _____ | _____ |
| 7. Audits are routinely performed. | _____ | _____ | _____ | _____ | _____ |
| 8. The internal auditors are independent of the activities they audit. | _____ | _____ | _____ | _____ | _____ |
| 9. Internal auditors have adequate training and experience. | _____ | _____ | _____ | _____ | _____ |
| 10. Internal auditors document the planning and execution of their work by such means as audit programs and working papers. | _____ | _____ | _____ | _____ | _____ |
| 11. Internal audit reports are submitted to the governing board or audit committee. | _____ | _____ | _____ | _____ | _____ |
| 12. Management responds appropriately to auditor recommendations on ways to strengthen internal control. | _____ | _____ | _____ | _____ | _____ |

| | | | | |
|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|
| <u>No Opinion</u> | <u>Strongly Disagree</u> | <u>Some- what Disagree</u> | <u>Some- what Agree</u> | <u>Strongly Agree</u> |
|-----------------------|------------------------------|------------------------------------|---------------------------------|---------------------------|

13. Procedures exist requiring prompt implementation of recommendations from audit findings, program evaluations, and management reviews.

II. Determine Other Areas For Evaluation

Section I of this form is the first of several forms that may be used to document your understanding of internal controls sufficiently to plan a primarily substantive audit. It is important to remember that in entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of the controls surrounding the electronic environment may not be enough. Because the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gain competent evidential matter—even in a primarily substantive approach. An auditor also should obtain an understanding of internal control over significant account balances and transactions. In the space provided below, determine which of the following areas apply. A “Yes” answer generally indicates you should complete the related form.

| | | |
|-----------|------------|-----------------------|
| <u>No</u> | <u>Yes</u> | <u>W/P References</u> |
|-----------|------------|-----------------------|

Computers or Outside Service Bureaus

1. The entity uses computers or outside computer service bureaus to process significant accounting information (see form at AAM section 12,030).

Significant Account Balances and Transaction Cycles

1. The following account balances or transaction cycles are significant to the entity's financial statements.
- a. Budgetary process (see form at AAM section 12,030.01).
 - b. Revenue cycle, including revenue, accounts receivable, and cash receipts (see form at AAM section 12,030.13). (Normally considered significant for governmental entities.)
 - c. Purchasing cycle, including expenditures/expenses, payables, and cash disbursements (see form at AAM section 12,030.25). (Normally considered significant for governmental entities.)

| | <u>No</u> | <u>Yes</u> | <u>W/P References</u> |
|--|-----------|------------|-----------------------|
| Significant Account Balances and Transaction Cycles—(cont'd) | | | |
| d. Cash and investments (see form at AAM section 12,030.37). | _____ | _____ | _____ |
| e. Fixed assets (see form at AAM section 12,030.49). | _____ | _____ | _____ |
| f. Payroll cycle (see form at AAM section 12,030.61). (Normally considered significant for governmental entities.) | _____ | _____ | _____ |
| g. Others (list): _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ |

III. Assess Segregation of Duties

An appropriate segregation of duties often appears to present difficulties in small governmental entities or accounting offices with only a few personnel. However, even smaller entities can usually divide responsibilities to achieve the necessary checks and balances. But if that is not possible—as may occasionally be the case—direct oversight of the incompatible activities by management or the governing board can provide the necessary control. For example, it is not uncommon, where there is a risk of improper cash payments in a small entity, for the governing board to periodically review a listing of all checks written. In the space provided below, assess risk due to a lack of segregation of duties for the entity, based on the completion of sections I and II of this form. Your comments should address—

- The person with incompatible responsibilities and the nature of those responsibilities.
- Any mitigating factors or controls, such as direct management oversight.
- The risk that material misstatements might occur as a result of a lack of segregation of duties, and the type of those misstatements.
- How substantive procedures will be designed to limit the risk of those misstatements to an acceptable level.

IV. Assess the Risk of Management Override

Even in effectively controlled entities—those with generally high levels of integrity and control consciousness—a manager might be able to override controls. The term “management override” means overruling prescribed policies or procedures for *illegitimate* purposes with the intent of personal gain or enhanced presentation of an entity’s financial condition or compliance status.

Management might override the control system for many reasons: to increase reported revenue or reduce reported deficits, to meet budgeted revenues or expenditures/expenses, to bolster bonus pay-outs tied to performance, to appear to cover violations of debt covenant agreements, or to hide lack of compliance with legal requirements. Override practices include deliberate misrepresentations to bankers, lawyers, accountants, and vendors, and intentionally issuing false documents. An active, involved governing board can significantly reduce the risk of management override.

Management override is different from management intervention, which is the overrule of prescribed policies or procedures for legitimate purposes. For example, management intervention is usually necessary to deal with non-recurring and non-standard transactions or events that otherwise might be handled by the system.

In the space below, assess the risk of management *override* for this entity. You should consider the risk that management override possibilities exist, the risk that management will take advantage of those possibilities, and any evidence that management has engaged in override practices. If the risk of management override is greater than low, indicate how planned audit procedures will reduce this risk to an acceptable level.

V. Interpret Results

You should consider the *collective* effect of the strengths and weaknesses in various control components. Management’s strengths and weaknesses may have a pervasive effect on internal control. For example, management controls may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by management to overstate earnings.

A. Areas That May Allow for Control Risk to be Assessed Below the Maximum

Based on the completion of sections I through IV of this form you may have become aware of certain accounts, transactions, and assertions

where it may be possible and efficient to plan a control risk assessment below the maximum. In the area below, document those accounts, transactions, and assertions and the related tests of controls.

| <u>Accounts, Transactions, and Assertions</u> | <u>Test of Controls Working Paper Reference</u> |
|---|---|
| <hr/> | <hr/> |
| <hr/> | <hr/> |
| <hr/> | <hr/> |
| <hr/> | <hr/> |

B. Areas of Possible Control Weakness

Based on the completion of sections I through IV of this form, you may have become aware of certain areas that may indicate possible control weaknesses, other than those areas relating to segregation of duties and management override that were assessed and documented in sections III and IV.

In the space provided below, document those areas of possible weakness and the impact the identified weakness will have on the audit. Discuss—

- The nature of the identified possible weakness.
- Any mitigating factors or controls, such as direct management oversight.
- The risk that material misstatements might occur as a result of the weakness and the type of those misstatements.
- How substantive procedures will be designed to reduce the risk of those misstatements to an acceptable level.

VI. Document Your Conclusions With Respect to Internal Controls

| | | | | |
|-------------------------|-------|-------|-------|-------|
| | 19__ | 19__ | 20__ | 20__ |
| Prepared or updated by: | _____ | _____ | _____ | _____ |
| Reviewed by: | _____ | _____ | _____ | _____ |

Appendix C

The Single Audit Act of 1984

[Deleted as a result of the issuance of Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*. See appendix M.]

Appendix D

Questions and Answers on the Single Audit Process of OMB Circular A-128

[Deleted as a result of the issuance of Statement of Position 98-3, Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards. See appendix M.]

Appendix E

OMB Circulars That Address Management of Federal Assistance Programs Applicable to State and Local Governments

[Deleted as a result of the issuance of Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*. See appendix M.]

Appendix F

The Common Rule—*Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments*

[Deleted as a result of the issuance of Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*. See appendix M.]

Appendix G

Key Events in the History of Auditing Federal Programs

[Deleted as a result of the issuance of Statement of Position 98-3, Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards. See appendix M.]

Appendix H

Single Audit Literature

[Deleted as a result of the issuance of Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*. See appendix M.]

Appendix I

Federal Quality Control Procedures

[Deleted as a result of the issuance of Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*. See appendix M.]

Appendix J

Acronyms and Abbreviations

AICPA—American Institute of Certified Public Accountants

ASBO—Association of School Business Officials

CAFR—Comprehensive Annual Financial Report

EEOC—Equal Employment Opportunity Commission

ERISA—Employee Retirement Income Security Act

FAF—Financial Accounting Foundation

FASB—Financial Accounting Standards Board

GAAFR—Governmental Accounting, Auditing, and Financial Reporting—
GFOA

GAAP—Generally Accepted Accounting Principles

GAAS—Generally Accepted Auditing Standards

GAGAS—Generally Accepted Government Auditing Standards

GAO—General Accounting Office, United States

GASAC—Governmental Accounting Standards Advisory Council

GASB—Governmental Accounting Standards Board

GFAAG—General Fixed Assets Account Group

GFOA—Government Finance Officers Association of the United States and
Canada

GLTDAG—General Long-Term Debt Account Group

GPFS—General-Purpose Financial Statements

HUD—Housing and Urban Development, U.S. Department of

IBNR—Incurred But Not Reported (Claims)

NACUBO—National Association of College and University Business Officials

NCGA—National Council on Governmental Accounting

OMB—Office of Management and Budget, United States

PERS—Public Employees Retirement System

SAS—Statement on Auditing Standards

SOP—Statement of Position by Committees of the AICPA

USDA—U.S. Department of Agriculture

YELLOW BOOK—*Government Auditing Standards* issued by Comptroller
General of the U.S., 1994

Appendix K

***Interpretation of SAS No. 41, Working Papers, Titled, "Providing Access to or Photocopies of Working Papers to a Regulator"*^{1,2}**

.01 Question—Paragraph 6 of SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339.06), states that “working papers are the property of the auditor and some states have statutes that designate the auditor as the owner of the working papers. The auditor’s rights of ownership, however, are subject to ethical limitations relating to the confidential relationship with clients.” In addition, paragraph 8 of SAS No. 41 (AICPA, *Professional Standards*, vol. 1, AU sec. 339.08) states that, “The auditor should adopt reasonable procedures for safe custody of his working papers and should retain them for a period sufficient to meet the needs of his practice and to satisfy any pertinent legal requirements of records retention.”

Notwithstanding the provisions of paragraphs 6 and 8 of SAS No. 41, auditors are sometimes required by law, regulation or audit contract,³ to provide a regulator, or a duly appointed representative, access to working papers. For example, a regulator may request access to the working papers to fulfill a quality review requirement or to assist in establishing the scope of a regulatory examination. Furthermore, as part of the regulator’s review of the working papers, the regulator may request photocopies of all or selected portions of the working papers during or after the review. The regulator may intend, or decide, to make photocopies (or information derived from the original working papers) available to others, including other governmental agencies, for their particular purposes, with or without the knowledge of the auditor or the client. When a regulator requests the auditor to provide access to (and possibly photocopies of) working papers pursuant to law, regulation or audit contract, what steps should the auditor take?

.02 Interpretation—When a regulator requests access to working papers pursuant to law, regulation or audit contract, the auditor should take the following steps:

- a. Consider advising the client that the regulator has requested access to (and possibly photocopies of) the working papers and that the aud-

¹ The term “regulator(s)” includes federal, state and local government officials with legal oversight authority over the entity. Examples of regulators who may request access to working papers include, but are not limited to, state insurance and utility regulators, various health care authorities, and federal agencies such as the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the Department of Housing and Urban Development, the Department of Labor, and the Rural Electrification Administration.

² The guidance in this Interpretation does not apply to requests from the Internal Revenue Service, firm practice-monitoring programs to comply with AICPA or state professional requirements such as peer or quality reviews, proceedings relating to alleged ethics violations, or subpoenas.

³ For situations in which the auditor is not required by law, regulation or audit contract to provide a regulator access to the working papers, reference should be made to the guidance in paragraphs .11-.15 of this Interpretation.

itor intends to comply with such request.⁴

- b. Make appropriate arrangements with the regulator for the review.
- c. Maintain control over the original working papers, and
- d. Consider submitting the letter described in paragraph .05 of this Interpretation to the regulator.

.03 The auditor should make appropriate arrangements with the regulator. These arrangements ordinarily would include the specific details such as the date, time and location of the review. The working papers may be made available to a regulator at the offices of the client, the auditor, or a mutually agreed-upon location, so long as the auditor maintains control. Furthermore, the auditor should take appropriate steps to maintain custody of the original working papers. For example, the auditor (or his or her representative) should consider being present when the original working papers are reviewed by the regulator. Maintaining control of the working papers is necessary to ensure the continued integrity of the working papers and to ensure confidentiality of client information.

.04 Ordinarily, the auditor should not agree to transfer ownership of the working papers to a regulator. Furthermore, the auditor should not agree, without client authorization, that the information contained therein about the client may be communicated to or made available to any other party. In this regard, the action of an auditor providing access to, or photocopies of, the working papers shall not constitute transfer of ownership or authorization to make them available to any other party.

.05 An audit performed in accordance with generally accepted auditing standards is not intended to, and does not, satisfy a regulator's oversight responsibilities. To avoid any misunderstanding, prior to allowing a regulator access to the working papers, the auditor should consider submitting a letter to the regulator that:

- a. Sets forth the auditor's understanding of the purpose for which access is being requested
- b. Describes the audit process and the limitations inherent in a financial statement audit
- c. Explains the purpose for which the working papers were prepared, and that any individual conclusions must be read in the context of the auditor's report on the financial statements
- d. States, except when not applicable, that the audit was not planned or conducted in contemplation of the purpose for which access is being granted or to assess the entity's compliance with laws and regulations

⁴ The auditor may wish (and in some cases may be required by law, regulation, or audit contract) to confirm in writing with the client that the auditor may be required to provide a regulator access to the working papers. Sample language that may be used follows:

"The working papers for this engagement are the property of (*name of auditor*) and constitute confidential information. However, we may be requested to make certain working papers available to (*name of regulator*) pursuant to authority given to it by law or regulation. If requested, access to such working papers will be provided under the supervision of (*name of auditor*) personnel. Furthermore, upon request, we may provide photocopies of selected working papers to (*name of regulator*). The (*name of regulator*) may intend, or decide, to distribute the photocopies or information contained therein to others, including other governmental agencies."

- e. States that the audit and the working papers should not supplant other inquiries and procedures that should be undertaken by the regulator for its purposes
- f. Requests confidential treatment under the Freedom of Information Act or similar laws and regulations,⁵ when a request for the working papers is made, and that written notice be given to the auditor before transmitting any information contained in the working papers to others, including other governmental agencies, except when such transfer is required by law or regulation, and
- g. States that if any photocopies are to be provided, they will be identified as “Confidential Treatment Requested by (*name of auditor, address, telephone number*).”

The auditor may wish to obtain a signed acknowledgment copy of the letter as evidence of the regulator’s receipt of the letter.

.06 An example of a letter containing the elements described in paragraph .05 of this Interpretation is presented below:

Illustrative Letter to Regulator⁶

(Date)

(Name and Address of Regulatory Agency)

Your representatives have requested access to our working papers in connection with our audit of the December 31, 19XX financial statements of (*name of client*). It is our understanding that the purpose of your request is (*state purpose: for example, “to facilitate your regulatory examination”*).⁷

Our audit of (*name of client*) December 31, 19XX financial statements was conducted in accordance with generally accepted auditing standards,⁸ the objective⁹ of which is to form an opinion as to whether the financial statements, which are the responsibility and representations of management, present fairly, in all material respects, the financial position, results of operations and cash flows in conformity with generally accepted accounting principles.¹⁰ Under generally accepted auditing standards, we have the responsibility, within the inherent limitations of the auditing process, to design our audit to provide reasonable assurance that errors and irregularities that have a ma-

⁵ The auditor may need to consult the regulations of individual agencies and, if necessary, consult with legal counsel regarding the specific procedures and requirements necessary to gain confidential treatment.

⁶ The auditor should appropriately modify this letter when the audit has been performed in accordance with generally accepted auditing standards and also in accordance with additional auditing requirements specified by a regulatory agency (for example, the requirements specified in *Government Auditing Standards* issued by the Comptroller General of the United States).

⁷ If the auditor is not required by law, regulation, or audit contract to provide a regulator access to the working papers but otherwise intends to provide such access (see paragraphs .11-.15 of this Interpretation), the letter should include a statement that: “Management of (*name of client*) has authorized us to provide you access to our working papers for (*state purpose*).”

⁸ Refer to footnote 6.

⁹ In an audit performed in accordance with the *Single Audit Act of 1984*, and certain other federal audit requirements, an additional objective of the audit is to assess compliance with laws and regulations applicable to federal financial assistance. Accordingly, in these situations, the above letter should be modified to include the additional objective.

¹⁰ If the financial statements have been prepared in conformity with regulatory accounting practices, the phrase “financial position, results of operations and cash flows in conformity with generally accepted accounting principles” should be replaced with appropriate wording such as, in the case of an insurance company, the “admitted assets, liabilities . . . of the XYZ Insurance Company in conformity with accounting practices prescribed or permitted by the state of . . . insurance department.”

terial effect on the financial statements will be detected, and to exercise due care in the conduct of our audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and as to the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Thus, our audit, based on the concept of selective testing, is subject to the inherent risk that material errors or irregularities, if they exist, would not be detected. In addition, an audit does not address the possibility that material errors or irregularities may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may have existed that would have been assessed differently by you.

The working papers were prepared for the purpose of providing the principal support for our report on (*name of client*) December 31, 19XX financial statements and to aid in the conduct and supervision of our audit. The working papers document the procedures performed, the information obtained and the pertinent conclusions reached in the engagement. The audit procedures that we performed were limited to those we considered necessary under generally accepted auditing standards¹¹ to enable us to formulate and express an opinion on the financial statements¹² taken as a whole. Accordingly, we make no representation as to the sufficiency or appropriateness, for your purposes, of either the information contained in our working papers or our audit procedures. In addition, any notations, comments, and individual conclusions appearing on any of the working papers do not stand alone, and should not be read as an opinion on any individual amounts, accounts, balances or transactions.

Our audit of (*name of client*) December 31, 19XX financial statements was performed for the purpose stated above and has not been planned or conducted in contemplation of your (*state purpose: for example, "regulatory examination"*) or for the purpose of assessing (*name of client*) compliance with laws and regulations.¹³ Therefore, items of possible interest to you may not have been specifically addressed. Accordingly, our audit and the working papers prepared in connection therewith, should not supplant other inquiries and procedures that should be undertaken by the (*name of regulatory agency*) for the purpose of monitoring and regulating the financial affairs of the (*name of client*). In addition, we have not audited any financial statements of (*name of client*) since (*date of audited balance sheet referred to in the first paragraph above*) nor have we performed any audit procedures since (*date*), the date of our auditor's report, and significant events or circumstances may have occurred since that date.

The working papers constitute and reflect work performed or information obtained by (*name of auditor*) in its capacity as independent auditor for (*name of client*). The documents contain trade secrets and confidential commercial and financial information of our firm and (*name of client*) that is privileged and confidential, and we expressly reserve all rights with respect to disclosures to third parties. Accordingly, we request confidential treatment under the Freedom of Information Act or similar laws and regulations¹⁴ when requests are made for the working papers or information contained therein or any documents created by the (*name of regulatory agency*) containing information

¹¹ Refer to footnote 6.

¹² Refer to footnote 9.

¹³ Refer to footnote 9.

¹⁴ This illustrative paragraph may not in and of itself be sufficient to gain confidential treatment under the rules and regulations of certain regulatory agencies. The auditor should consider tailoring this paragraph to the circumstances after consulting the regulations of each applicable regulatory agency and, if necessary, consult with legal counsel regarding the specific procedures and requirements to gain confidential treatment.

derived therefrom. We further request that written notice be given to our firm before distribution of the information in the working papers (or photocopies thereof) to others, including other governmental agencies, except when such distribution is required by law or regulation.

[If it is expected that photocopies will be requested, add:

Any photocopies of our working papers we agree to provide you will be identified as "Confidential Treatment Requested by (*name of auditor, address, telephone number*)."]

Firm signature

.07 Question—A regulator may request access to the working papers before the audit has been completed and the report released. May the auditor allow access in such circumstances?

.08 Interpretation—When the audit has not been completed, the working papers are necessarily incomplete because (a) additional information may be added as a result of further tests and review by supervisory personnel and (b) any audit results and conclusions reflected in the incomplete working papers may change. Accordingly, it is preferable that access be delayed until all audit procedures have been completed and all internal reviews have been performed. If access is provided prior to completion of the audit, the auditor should consider issuing the letter referred to in paragraph .05 of this Interpretation, appropriately modified, and including additional language along the following lines:

"We have been engaged to audit in accordance with generally accepted auditing standards the December 31, 19XX, financial statements of XYZ Company, but have not as yet completed our audit. Accordingly, at this time we do not express any opinion on the Company's financial statements. Furthermore, the contents of the working papers may change as a result of additional audit procedures and review of the working papers by supervisory personnel of our firm. Accordingly, our working papers are incomplete."

Because the working papers may change prior to completion of the audit, the auditor ordinarily should not provide photocopies of the working papers until the audit has been completed.

.09 Question—Some regulators may engage an independent party, such as another independent public accountant, to perform the working paper review on behalf of the regulatory agency. Are there any special precautions the auditor should observe in these circumstances?

.10 Interpretation—The auditor should be satisfied that the party engaged by the regulator is subject to the same confidentiality restrictions as the regulatory agency itself. This can be accomplished by obtaining acknowledgment, preferably in writing, from the regulator stating that the third party is acting on behalf of the regulator and agreement from the third party that he or she is subject to the same restrictions on disclosure and use of working papers and the information contained therein as the regulator.

.11 Question—When a regulator requests the auditor to provide access to (and possibly photocopies of) working papers and the auditor is not otherwise required by law, regulation or audit contract to provide such access, what steps should the auditor take?

.12 Interpretation—The auditor should obtain an understanding of the reasons for the regulator's request for access to the working papers and may wish to consider consulting with legal counsel regarding the request. If the auditor decides to provide such access, the auditor should obtain the client's consent, preferably in writing, to provide the regulator access to the working papers.

.13 Following is an example of language that may be used in the written communication to the client:

“The working papers for this engagement are the property of *(name of auditor)* and constitute confidential information. However, we have been requested to make certain working papers available to *(name of regulator)* for *(describe the regulator’s basis for its request)*. Access to such working papers will be provided under the supervision of *(name of auditor)* personnel. Furthermore, upon request, we may provide photocopies of selected working papers to *(name of regulator)*.”

“You have authorized *(name of auditor)* to allow *(name of regulator)* access to the working papers in the manner discussed above. Please confirm your agreement to the above by signing below and returning to *(name of auditor, address)*.”

Firm signature

Agreed and acknowledged:

(Name and title)

(Date)

.14 If the client requests to review the working papers before allowing the regulator access, the auditor may provide the client with the opportunity to obtain an understanding of the nature of the information about its financial statements contained in the working papers that are being made available to the regulator. When a client reviews the working papers, the auditor should maintain control of the working papers as discussed in paragraph .03 of this Interpretation.

.15 The auditor should also refer to the guidance in paragraphs .03-.10 of this Interpretation which provide guidance on making arrangements with the regulator for access to the working papers, maintaining control over the original working papers and submitting a letter describing various matters to the regulator.

[Issue Date: July, 1994; Revised: June, 1996.]

Appendix L

**Statement of
Position**

98-2

**Accounting for Costs of
Activities of Not-for-Profit
Organizations and State and
Local Governmental Entities
That Include Fund Raising**

March 11, 1998

**Amendment to
AICPA Audit and Accounting Guides
*Health Care Organizations,
Not-for-Profit Organizations, and
Audits of State and Local Governmental Units***

**Issued by the Accounting
Standards Executive Committee**

AAG-SLG APP L

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by either the Financial Accounting Standards Board (for financial statements of nongovernmental entities) or the Governmental Accounting Standards Board (for financial statements of state and local governmental entities), as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) applies to all nongovernmental not-for-profit organizations (NPOs) and all state and local governmental entities that solicit contributions.

This SOP requires—

- If the criteria of purpose, audience, and content as defined in this SOP are met, the costs of joint activities that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function.
- If any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.
- Certain financial statement disclosures if joint costs are allocated.
- Some commonly used and acceptable allocation methods are described and illustrated although no methods are prescribed or prohibited.

This SOP amends existing guidance in AICPA Audit and Accounting Guides *Health Care Organizations*, *Not-for-Profit Organizations* (which was issued in August 1996 and supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into the Guide), and *Audits of State and Local Governmental Units*.

This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB and the GASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members and three of the five GASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.*

The criteria applied by the FASB and the GASB in their review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB and the GASB will propose suggestions, many of which are included in the documents.

* This document was cleared prior to July 1, 1997. In July 1997, the GASB increased to seven members. Documents considered by the GASB after July 1, 1997 are cleared if at least four of the seven GASB members do not object.

Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising

Introduction

1. Some nongovernmental not-for-profit organizations (NPOs) and some state and local governmental entities,¹ such as governmental colleges and universities and governmental health care providers, solicit support through a variety of **fund-raising activities**.² These **activities** include direct mail, telephone solicitation, door-to-door canvassing, telethons, special events, and others. Sometimes fund-raising activities are conducted with activities related to other functions, such as **program activities** or supporting services, such as **management and general activities**.³ Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund raising.

2. External users of financial statements—including contributors, creditors, accreditation agencies, and regulators—want assurance that fund-raising costs, as well as program costs and management and general costs, are stated fairly.

3. In 1987, the AICPA issued Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*.⁴ SOP 87-2 required that all circumstances concerning informational materials and activities that include a fund-raising appeal be considered in accounting for **joint costs** of those

¹ This Statement of Position (SOP) uses the term *entity* to refer to both nongovernmental not-for-profit organizations (NPOs) and state and local governments.

² Terms that appear in the Glossary are set in **boldface type** the first time they appear.

³ The functional classifications of fund raising, program, and management and general are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Some entities have a functional structure that does not include fund raising, program, or management and general, or that includes other functional classifications, such as **membership development**. This SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. In circumstances in which entities that have a functional structure that includes other functional classifications conduct joint activities, all costs of those joint activities should be charged to fund raising (or the category in which fund raising is reported—see the following two parenthetical sentences), unless the purpose, audience, and content of those joint activities are appropriate for achieving those other functions. (An example of an entity that reports fund raising in a category other than fund raising is a state and local governmental entity applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8. As discussed in paragraph D-5 of this SOP, those entities are required to report fund raising as part of the “institutional support” function.)

⁴ In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*. The Guide supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into paragraphs 13.31 to 13.40 of *Not-for-Profit Organizations*. *Not-for-Profit Organizations* applies to all nongovernmental NPOs other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.31 to 13.40 of *Not-for-Profit Organizations*. Also, SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.

materials and activities and that certain criteria be applied in determining whether joint costs of those materials and activities should be charged to fund raising or allocated to program or management and general. Those criteria include requiring verifiable indications of the reasons for conducting the activity, such as the content, audience, and action, if any, requested of the participant, as well as other corroborating evidence. Further, SOP 87-2 required that all joint costs of those materials and activities be charged to fund raising unless the appeal is designed to motivate its audience to action other than providing financial support to the organization.

4. The provisions of SOP 87-2 have been difficult to implement and have been applied inconsistently in practice. (Appendix B, “Background,” discusses this further.)

5. This SOP establishes financial accounting standards for accounting for **costs of joint activities**. In addition, this SOP requires financial statement disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Appendix F provides explanations and illustrations of some acceptable allocation methods.

Scope

6. This SOP applies to all nongovernmental NPOs and all state and local governmental entities that solicit **contributions**.

Conclusions

Accounting for Joint Activities

7. If the criteria of purpose, audience, and content are met, the costs of a **joint activity** that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

Purpose

8. The purpose criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions. (Paragraphs 9 and 10 provide guidance that should be considered in determining whether the purpose criterion is met. Paragraph 9 provides guidance pertaining to program functions only. Paragraph 10 provides guidance pertaining to both program and management and general functions.)

9. *Program functions.* To accomplish program functions, the activity should call for specific action by the audience that will **help accomplish the entity’s mission**. For purposes of applying the guidance in this SOP, the following are examples of activities that do and do not call for specific action by the audience that will help accomplish the entity’s mission:

- An entity's mission includes improving individuals' physical health. For that entity, motivating the audience to take specific action that will improve their physical health is a call for specific action by the audience that will help accomplish the entity's mission. An example of an activity that motivates the audience to take specific action that will improve their physical health is sending the audience a brochure that urges them to stop smoking and suggests specific methods, instructions, references, and resources that may be used to stop smoking.
- An entity's mission includes educating individuals in areas other than the causes, conditions, needs, or concerns that the entity's programs are designed to address (referred to hereafter in this SOP as "causes"). For that entity, educating the audience in areas other than causes or motivating the audience to otherwise engage in specific activities that will educate them in areas other than causes is a call for specific action by the audience that will help accomplish the entity's mission. Examples of entities whose mission includes educating individuals in areas other than causes are universities and possibly other entities. An example of an activity motivating individuals to engage in education in areas other than causes is a university inviting individuals to attend a lecture or class in which the individuals will learn about the solar system.
- Educating the audience about causes or motivating the audience to otherwise engage in specific activities that will educate them about causes is not a call for specific action by the audience that will help accomplish the entity's mission. Such activities are considered in support of fund raising. (However, some educational activities that might otherwise be considered as educating the audience about causes may implicitly call for specific action by the audience that will help accomplish the entity's mission. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to increase recycling. If the need for and benefits of the specific action are clearly evident from the educational message, the message is considered to include an implicit call for specific action by the audience that will help accomplish the entity's mission.)
- Asking the audience to make contributions is not a call for specific action by the audience that will help accomplish the entity's mission.

If the activity calls for specific action by the audience that will help accomplish the entity's mission, the guidance in paragraph 10 should also be considered in determining whether the purpose criterion is met.

10. *Program and management and general functions.* The following factors should be considered, in the order in which they are listed,⁵ to determine whether the purpose criterion is met:

- a. *Whether compensation or fees for performing the activity are based on contributions raised.* The purpose criterion is *not* met if a majority of compensation or fees for any party's performance of any com-

⁵ In considering the guidance in paragraph 10, the factor in paragraph 10a (the compensation or fees test) is the preeminent guidance. If the factor in paragraph 10a is not determinative, the factor in paragraph 10b (whether a similar program or management and general activity is conducted separately and on a similar or greater scale) should be considered. If the factor in paragraph 10b is not determinative, the factor in paragraph 10c (other evidence) should be considered.

ponent of the discrete joint activity varies based on contributions raised for that discrete joint activity.^{6,7}

- b. *Whether a similar program or management and general activity is conducted separately and on a similar or greater scale.* The purpose criterion is met if either of the following two conditions is met:

(1) *Condition 1:*

- The program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and
- A similar program component is conducted without the fund-raising component using the same **medium** and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.⁸

(2) *Condition 2:*

A management and general activity that is similar to the management and general component of the joint activity being accounted for is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.

If the purpose criterion is met based on the factor in paragraph 10b, the factor in paragraph 10c should not be considered.

- c. *Other evidence.* If the factors in paragraph 10a or 10b do not determine whether the purpose criterion is met, other evidence may determine whether the criterion is met. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

11. The following are examples of indicators that provide evidence for determining whether the purpose criterion is met:

- a. Evidence that the purpose criterion may be met includes—

- *Measuring program results and accomplishments of the activity.* The facts may indicate that the purpose criterion is met if the entity measures program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes).

⁶ Some compensation contracts provide that compensation for performing the activity is based on a factor other than contributions raised, but not to exceed a specified portion of contributions raised. For example, a contract may provide that compensation for performing the activity is \$10 per contact hour, but not to exceed 60 percent of contributions raised. In such circumstances, compensation is not considered based on amounts raised, unless the stated maximum percentage is met. In circumstances in which it is not yet known whether the stated maximum percentage is met, compensation is not considered based on amounts raised, unless it is probable that the stated maximum percentage will be met.

⁷ The *compensation or fees test* is a negative test in that it either (a) results in failing the purpose criterion or (b) is not determinative of whether the purpose criterion is met. Therefore, if the activity fails the purpose criterion based on this factor (the compensation or fees test), the activity fails the purpose criterion and the factor in paragraph 10b should not be considered. If the purpose criterion is not failed based on this factor, this factor is not determinative of whether the purpose criterion is met and the factor in paragraph 10b should be considered.

⁸ Determining the scale on which an activity is conducted may be a subjective determination. Factors to consider in determining the scale on which an activity is conducted may include dollars spent, the size of the audience reached, and the degree to which the characteristics of the audience are similar to the characteristics of the audience of the activity being evaluated.

- *Medium.* The facts may indicate that the purpose criterion is met if the program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and if the entity conducts the program component without a significant fund-raising component in a different medium. Also, the facts may indicate that the purpose criterion is met if the entity conducts the management and general component of the joint activity without a significant fund-raising component in a different medium.
- b. Evidence that the purpose criterion may not be met includes—
- *Evaluation or compensation.* The facts may indicate that the purpose criterion is not met if (a) the evaluation of any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity or (b) some, but less than a majority, of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.
- c. Evidence that the purpose criterion may be either met or not met includes—
- *Evaluation of measured results of the activity.* The entity may have a process to evaluate measured program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes). If the entity has such a process, in evaluating the effectiveness of the joint activity, the entity may place significantly greater weight on the activity's effectiveness in accomplishing program goals or may place significantly greater weight on the activity's effectiveness in raising contributions. The former may indicate that the purpose criterion is met. The latter may indicate that the purpose criterion is not met.
 - *Qualifications.* The qualifications and duties of those performing the joint activity should be considered.
 - If a third party, such as a consultant or contractor, performs part or all of the joint activity, such as producing brochures or making telephone calls, the third party's experience and the range of services provided to the entity should be considered in determining whether the third party is performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity.
 - If the entity's employees perform part or all of the joint activity, the full range of their job duties should be considered in determining whether those employees are performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity. For example, (a) employees who are not members of the fund-raising department and (b) employees who are members of the fund-raising department but who perform non-fund-raising activities are more likely to perform activities that include program or management and general functions than are employees who otherwise devote significant time to fund raising.

- *Tangible evidence of intent.* Tangible evidence indicating the intended purpose of the joint activity should be considered. Examples of such tangible evidence include
 - The entity's written mission statement, as stated in its fund-raising activities, bylaws, or annual report.
 - Minutes of board of directors', committees', or other meetings.
 - Restrictions imposed by donors (who are not related parties) on gifts intended to fund the joint activity.
 - Long-range plans or operating policies.
 - Written instructions to other entities, such as script writers, consultants, or list brokers, concerning the purpose of the joint activity, audience to be targeted, or method of conducting the joint activity.
 - Internal management memoranda.

Audience

12. A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for one or more of the reasons in paragraph 13a, 13b, or 13c. In determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for one or more of the reasons in paragraph 13a, 13b, or 13c. For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

13. In circumstances in which the audience includes no prior donors and is not otherwise selected based on its ability or likelihood to contribute to the entity, the audience criterion is met if the audience is selected for one or more of the following reasons:

- a. The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity
- b. The audience's ability to take specific action to assist the entity in meeting the goals of the program component of the joint activity
- c. The entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component

Content

14. The content criterion is met if the joint activity supports program or management and general functions, as follows:

- a. *Program.* The joint activity calls for specific action by the recipient that will help accomplish the entity's mission. If the need for and benefits of the action are not clearly evident, information describing the action and explaining the need for and benefits of the action is provided.

- b. *Management and general.* The joint activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity.⁹

15. Information identifying and describing the entity, causes, or how the contributions provided will be used is considered in support of fund raising.

Allocation Methods

16. The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances.

Incidental Activities

17. Some fund-raising activities conducted in conjunction with program or management and general activities are incidental to such program or management and general activities. For example, an entity may conduct a fund-raising activity by including a generic message, "Contributions to Organization X may be sent to [address]" on a small area of a message that would otherwise be considered a program or management and general activity based on its purpose, audience, and content. That fund-raising activity likely would be considered incidental to the program or management and general activity being conducted. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. For example, an entity may conduct a program activity by including a generic program message such as "Continue to pray for [a particular cause]" on a small area of a message that would otherwise be considered fund raising based on its purpose, audience, and content. That program activity would likely be considered incidental to the fund-raising activity being conducted. Similarly, an entity may conduct a management and general activity by including a brief management and general message—"We recently changed our phone number. Our new number is 123-4567"—on a small area of a message that would otherwise be considered a program or fund-raising activity based on its purpose, audience, and content. That management and general activity would likely be considered incidental to the program or fund-raising activity being conducted. In circumstances in which a fund-raising, program, or management and general activity is conducted in conjunction with another activity and is incidental to that other activity, and the conditions in this SOP for allocation are met, joint costs are permitted but not required to be allocated and may therefore be charged to the functional classification related to the activity that is not the incidental activity. However, in circumstances in which the program or management and general activities are incidental to the fund-raising activities, it is unlikely that the conditions required by this SOP to permit allocation of joint costs would be met.

Disclosures

18. Entities that allocate joint costs should disclose the following in the notes to their financial statements:

⁹ Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. For purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities.

- a. The types of activities for which joint costs have been incurred
- b. A statement that such costs have been allocated
- c. The total amount allocated during the period and the portion allocated to each functional expense category

19. This SOP encourages, but does not require, that the amount of joint costs for each kind of joint activity be disclosed, if practical.

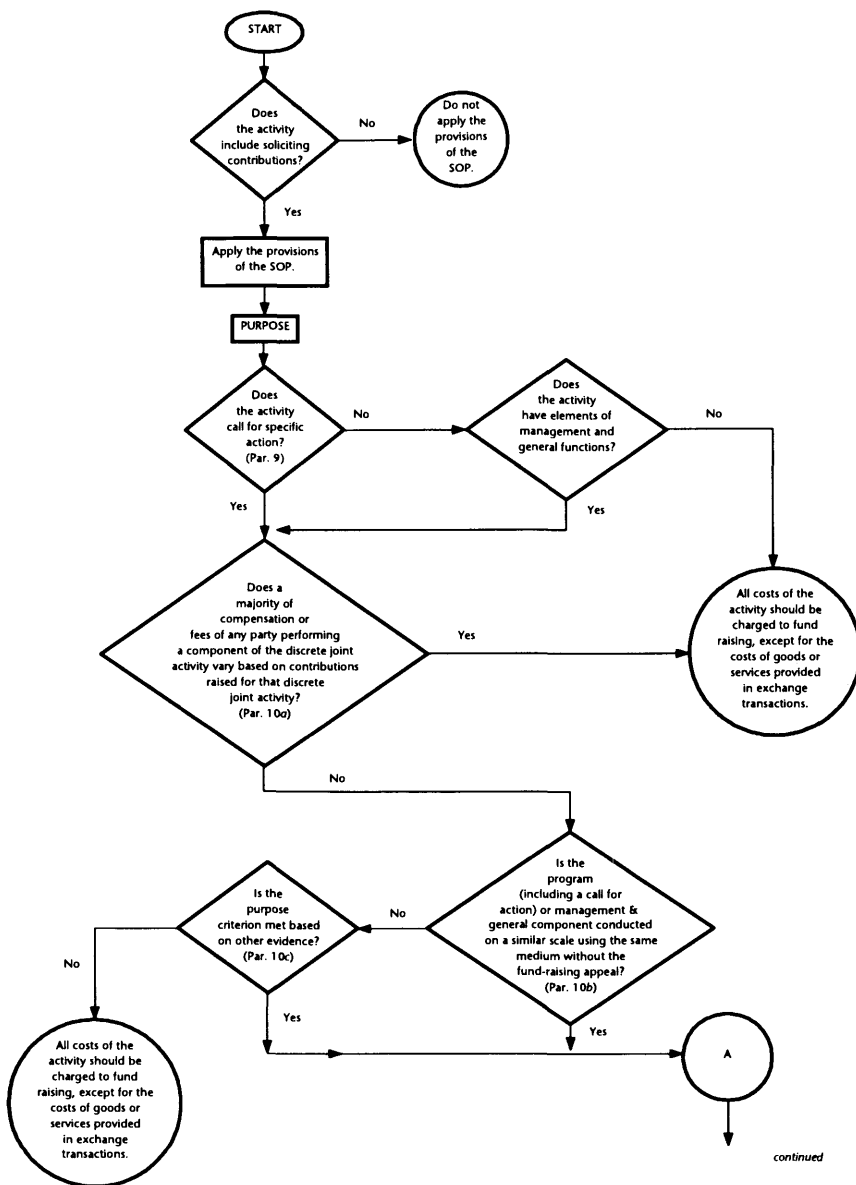
Effective Date

20. This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

**The provisions of this Statement of Position need
not be applied to immaterial items.**

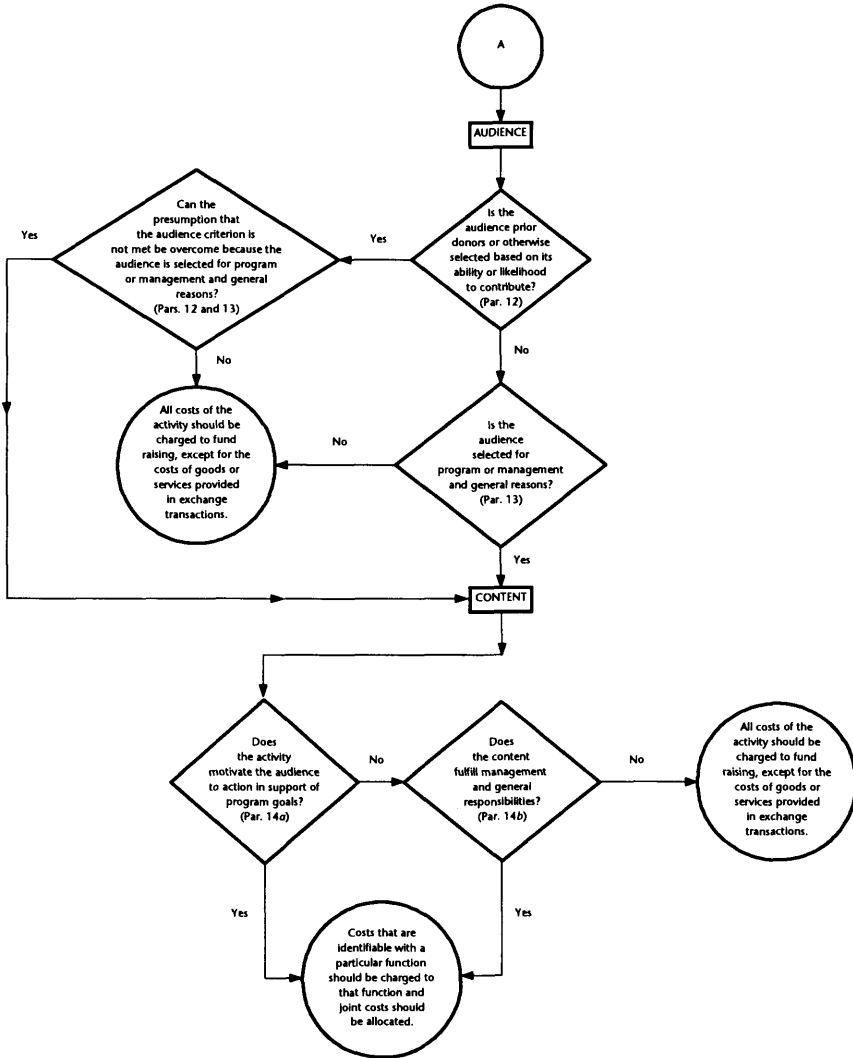
APPENDIX A

Accounting for Joint Activities¹⁰



continued

¹⁰ **Note:** This flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.



APPENDIX B

Background

B.1. As stated in paragraph 4, the provisions of Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, have been difficult to implement and applied inconsistently in practice. That difficulty has been due in part to the following:

- The second sentence of paragraph 1 of SOP 87-2 stated that “some of the costs incurred by such organizations are clearly identifiable with fundraising, such as the cost of fund-raising consulting services.” It is unclear whether activities that would otherwise be considered program activities should be characterized as program activities if they are performed or overseen by professional fund raisers. Also, it is unclear whether activities would be reported differently (for example, as program rather than fund raising) depending on whether the fund-raising consultant is compensated by a predetermined fee or by some other method, such as a percentage of contributions raised.
- SOP 87-2 was unclear about whether allocation of costs to fund-raising expense is required if the activity for which the costs were incurred would not have been undertaken without the fund-raising component.
- SOP 87-2 defined joint costs through examples, and it is therefore unclear what kinds of costs were covered by SOP 87-2. For example, it is unclear whether salaries and indirect costs can be joint costs.
- Some believe the guidance in SOP 87-2 was inadequate to determine whether joint activities, such as those that request contributions and also list the warning signs of a disease, are designed to motivate their audiences to action other than to provide contributions to the entity. It is unclear what attributes the targeted audience should possess in order to conclude that a program function is being conducted.

B.2. In 1992, the Accounting Standards Executive Committee (AcSEC) undertook a project to supersede SOP 87-2, to provide clearer guidance than that provided by SOP 87-2, as well as to provide guidance that would improve on the guidance in SOP 87-2. In September 1993, AcSEC released an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, for public comment. AcSEC received more than 300 comment letters on the exposure draft. AcSEC redeliberated the issues based on the comments received.

B.3. In 1996, after redeliberating the issues based on the comments received and making certain revisions to the draft SOP, AcSEC conducted a field test of the draft SOP. The objectives of the field test were to determine whether the provisions of the draft SOP were sufficiently clear and definitive to generate consistent and comparable application of the SOP. Based on the field test results, AcSEC concluded that the provisions of the draft SOP, with certain revisions, were sufficiently clear and definitive to generate consistent and comparable application of the SOP.

B.4. Some respondents who commented on the exposure draft, as well as some interested parties who followed the project through its due process subsequent to the exposure draft, commented that the SOP should be reexposed for public comment. Reasons cited include:

- Approximately three years had passed between the end of the comment period and AcSEC's decision to issue the SOP.
- AcSEC made significant revisions to the SOP subsequent to releasing the exposure draft for comment.

Considering whether a proposed standard should be reexposed for public comment is inherently a subjective process. Factors that AcSEC considered include—

- The significance of changes made to the exposure draft and whether those changes result in guidance that the public did not have an opportunity to consider.
- Whether the scope was revised in such a way that affected entities did not have an opportunity to comment.
- New information about or changes in the nature of the transactions being considered, practice, or other factors.

AcSEC believes that the length of time between exposure and final issuance is not pertinent to whether the SOP should be reexposed for public comment.

B.5. Based on consideration of the factors identified, AcSEC believes that the SOP should not be reexposed for public comment. AcSEC notes that although the SOP has been revised based on comments received on the exposure draft, those revisions do not change the overall model in the SOP. Those revisions were made primarily to clarify the SOP and improve its operationality. Further, AcSEC believes that the project received a high level of attention from interested parties. AcSEC provided working drafts to interested parties and those parties provided input throughout the process, up to and including the Financial Accounting Standard Board's and the Governmental Accounting Standards Board's clearance of the SOP for issuance.

B.6. Appendix C discusses the key issues in the exposure draft and comments received on those issues, as well as the basis for AcSEC's conclusions on those and certain other issues.

APPENDIX C

Basis for Conclusions

C.1. This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Overall Framework

C.2. This SOP uses the model in SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, as a starting point and clarifies guidance that was unclear, provides more detailed guidance, revises some guidance, and expands the scope of costs covered to include all costs of joint activities. The model established by SOP 87-2 was to account for joint costs as fund raising unless an entity could demonstrate that a program or management and general function had been conducted. SOP 87-2 used verifiable indications of the reasons for conducting the activity, such as content, audience, the action requested, if any, and other corroborating evidence as a basis for determining whether a program or management and general function had been conducted.

C.3. On an overall basis, the majority of respondents who commented on the September 1993 exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, opposed it, for various reasons, including the following:

- The guidance in SOP 87-2 is operational, results in sound financial reporting, and should be retained.
- The guidance in SOP 87-2 should be retained but clarified.
- The guidance proposed in the exposure draft should be revised. (Some commented that it overstates fund raising; others commented that it understates fund raising.)

C.4. AcSEC concluded that it supports the model in the exposure draft, subject to certain revisions. AcSEC believes that this SOP provides clear, detailed accounting guidance that, when applied, will increase comparability of financial statements. Those statements will also include more meaningful disclosures without incurring increased costs.

C.5. Some respondents commented that the model in the exposure draft would adversely affect entities both financially and operationally. Various reasons were given, including the following:

- It would inhibit the ability of entities, particularly small entities and entities that raise contributions through direct solicitations, to generate the necessary revenue to perform their program services.
- Most entities would not meet the criteria in this SOP for reporting costs of joint activities as program or management and general, because they must combine their mission statements, public information and education, and fund-raising appeals due to a lack of resources. Some noted that this may result in unsatisfactory ratings from public watchdog groups.

AcSEC did not find these arguments compelling. This SOP provides accounting guidance; it provides no guidance concerning how entities should undertake their activities. Also, this SOP does not prohibit allocation merely because activities carrying out different functions are combined. In fact, this SOP provides guidance for reporting costs as program or management and general in circumstances in which those activities are combined with fund-raising. Moreover, actions taken by financial statement users are not the direct result of the requirements of this SOP. Rather, those actions may result from more relevant and useful information on which to base decisions.

C.6. Some respondents commented that the exposure draft is biased toward reporting expenses as fund raising. AcSEC believes that determining whether the costs of joint activities should be classified as program, management and general, or fund raising sometimes is difficult, and such distinctions sometimes are subject to a high degree of judgment. AcSEC believes that external financial statement users focus on and have perceptions about amounts reported as program, management and general, and fund raising. That focus and those perceptions provide incentives for entities to report expenses as program or management and general rather than fund raising. Therefore, in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. The criteria in this SOP provide guidance for entities to overcome that presumption.

Accounting for Joint Activities

C.7. This SOP requires that if any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund raising, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising. (This SOP expands on the model established by SOP 87-2 by including all costs of joint activities other than costs of goods or services provided in exchange transactions, rather than merely joint costs.) AcSEC believes that the criteria of purpose, audience, and content are each relevant in determining whether a joint activity should be reported as fund raising, program, or management and general because each provides significant evidence about the benefits expected to be obtained by undertaking the activity.

C.8. Some respondents commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising is misleading and that the scope of the SOP should include only joint costs of joint activities. Some commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising conflicts with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, which defines fund raising, program, and management and general and requires not-for-profit organizations (NPOs) to report information about expenses using those functional classifications.

C.9. AcSEC believes that the purpose for which costs other than joint costs are incurred may be fund raising, program, or management and general,

depending on the context in which they are used in the activity undertaken. For example, a program-related pamphlet may be sent to an audience in need of the program. In that context, the pamphlet is used for program purposes. However, in order to demonstrate to potential donors that the entity's programs are worthwhile, that same pamphlet may be sent to an audience that is likely to contribute, but that has no need or reasonable potential for use of the program. In that context, the pamphlet is used for fund raising. AcSEC believes this broader scope will result in more comparability and more meaningful financial reporting by covering all costs of activities that include fund raising and by assigning those costs to the function for which they are incurred, consistent with the guidance in Statement No. 117.

C.10. AcSEC believes that costs of goods or services provided in exchange transactions should not be charged to fund raising because those costs are incurred in exchange for revenues other than contributions.

Criteria of Purpose, Audience, and Content

Call For Action

C.11. The definition of *program* in FASB Statement No. 117 includes public education. As noted in paragraph C.6, AcSEC believes that in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. AcSEC believes that in order to overcome that presumption, it is not enough that (a) the purpose of the activity include educating the public about causes, (b) the audience has a need or reasonable potential for use of any educational component of the activity pertaining to causes, or (c) the audience has the ability to assist the entity in meeting the goals of the program component of the activity by becoming educated about causes. Therefore, AcSEC concluded that for purposes of this SOP, in order to conclude that the criteria of purpose, audience, and content are met program activities are required to call for specific action by the recipient (other than becoming educated about causes) that will help accomplish the entity's mission. As discussed in paragraph 9, in certain circumstances educational activities may call for specific action by the recipient that will help accomplish the entity's mission.

Purpose

C.12. AcSEC believes meeting the purpose criterion demonstrates that the purpose of the activity includes accomplishing program or management and general functions. Inherent in the notion of a joint activity is that the activity has elements of more than one function. Accordingly, the purpose criterion provides guidance for determining whether the purpose of the activity includes accomplishing program or management and general functions in addition to fund raising.

Compensation and Evaluation Tests

C.13. The exposure draft proposed that all costs of the joint activity should be charged to fund raising if (a) substantially all compensation or fees for performing the activity are based on amounts raised or (b) the evaluation of the party performing the activity is based on amounts raised. Some respondents commented that basing the method of compensation or evaluating the

performance of the party performing the activity based on contributions raised should not lead to the conclusion that all costs of the activity should be charged to fund raising. Others commented that the method of compensation is unrelated to whether the purpose criterion is met. The reasons given included the following:

- It is counterintuitive to imply that those performing multipurpose activities that include fund raising would not be compensated or evaluated based on amounts raised.
- Such guidance would create a bias toward entities that use employees to raise contributions and against entities that hire professional fund raisers and public relations firms and is therefore not neutral.

Some respondents gave examples of circumstances in which substantially all compensation is based on contributions raised and asserted that the activity was nevertheless a program activity. In each of those examples, AcSEC considered all the facts presented and concluded that the activity was fund raising.

C.14. AcSEC continues to support the spirit of the proposed guidance, because AcSEC believes that basing a majority of compensation on funds raised is persuasive evidence that the activity is a fund-raising activity. Nevertheless, AcSEC believes that the proposed guidance was unclear and would be difficult to implement, primarily because of the broad definition of “based on contributions raised” included in the glossary of the exposure draft. In connection with that issue, AcSEC was concerned that any joint activities performed by a fund-raising department or by individuals whose duties include fund raising, such as executive officers of small NPOs who are employed based on their ability to raise contributions, would be required to be reported as fund raising because the compensation of the parties performing those activities is based on amounts raised. Also, AcSEC had concerns that it would be difficult to determine whether fixed contract amounts were negotiated based on expected contributions. Therefore, AcSEC concluded that the compensation test should be revised to provide that the purpose criterion is not met if a majority of compensation or fees for any party’s performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity. AcSEC believes that guidance is sound and is operational.

C.15. AcSEC believes that the guidance in paragraph 10a is not biased against entities that hire professional fund raisers, because it applies to the entity’s employees as well as professional fund raisers. For example, if a majority of an employee’s compensation or fees for performing a component of a discrete joint activity varies based on contributions raised for that discrete joint activity, the purpose criterion is not met.

Similar Function-Similar Medium Test

C.16. Some respondents misinterpreted the exposure draft as providing that, in order to meet the purpose criterion, the program or management and general activity must be conducted without the fund-raising component, using the same medium and on a scale that is similar to or greater than the program or management and general component of the activity being accounted for. That was not a requirement proposed by the exposure draft. The exposure draft proposed that meeting that condition would result in meeting the purpose criterion. Failing the criterion merely leads to consideration of other evidence, such as the indicators in paragraph 11. AcSEC has revised the SOP to state this more clearly.

Other Evidence

C.17. The compensation test and the similar function-similar medium test may not always be determinative because the attributes that they consider may not be present. Therefore, this SOP includes indicators that should be considered in circumstances in which the compensation test and the similar function-similar medium test are not determinative. The nature of those indicators is such that they may be present in varying degrees. Therefore, all available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

Audience

C.18. The exposure draft proposed that if the audience for the materials or activities is selected principally on its ability or likelihood to contribute, the audience criterion is not met and all the costs of the activity should be charged to fund raising. Further, the exposure draft proposed that if the audience is selected principally based on its need for the program or because it can assist the entity in meeting its program goals other than by financial support provided to the entity, the audience criterion is met. Some respondents commented that that audience criterion is too narrow, because it is based on the principal reason for selecting the audience. They asserted that for some activities no principal reason exists for selecting an audience; entities select the audience for those activities for multiple reasons, such as both the audience's ability to contribute and its ability to help meet program goals. Some commented that for some activities, entities select audiences that have provided past financial support because, by providing financial support, those audiences have expressed an interest in the program.

C.19. AcSEC believes that meeting the audience criterion should demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions. Therefore, the reasons for selecting the audience should be consistent with the program or management and general content of the activity. However, AcSEC believes it is inherent in the notion of joint activities that the activity has elements of more than one function, including fund raising, and acknowledges that it may be difficult to determine the principal reason for selecting the audience. Accordingly, AcSEC concluded that if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute, a rebuttable presumption should exist that the audience was selected to raise funds. AcSEC believes that the reasons for selecting the audience that can overcome that presumption, which are included in paragraph 13 of this SOP, demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions based on the program or management and general content of the activity.

Content

C.20. AcSEC believes that meeting the content criterion demonstrates that the content of the activity supports program or management and general functions. AcSEC believes that accounting guidance should not impose value judgments about whether the entity's mission, programs, and responsibilities are worthwhile. Therefore, whether the content criterion is met depends on the relationship of the content to the entity's mission, programs, and management and general responsibilities.

C.21. Paragraph 14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. The exposure draft proposed that slogans, general calls to prayer, and general calls to protest do not meet the content criterion; some respondents disagreed. AcSEC concluded that this SOP should be silent concerning whether slogans, general calls to prayer, and general calls to protest are calls to action that meet the content criterion. AcSEC believes that determining whether those items are calls to action that meet the content criterion requires judgments based on the particular facts and circumstances.

C.22. Some respondents commented that educating the public about causes without calling for specific action should satisfy the content criterion. They noted that this is particularly relevant for NPOs subject to Internal Revenue Code (IRC) Section 501(c)4, because those NPOs are involved in legislative reform. Also, some noted that it may be the entity's mission or goal to educate the public about causes. They believe that, in those cases, the NPO's program is to educate the public about causes without necessarily calling for specific action by the recipient.

C.23. As discussed in paragraph C.11, AcSEC concluded that education that does not motivate the audience to action is in fact done in support of fund raising. However, this SOP acknowledges that some educational messages motivate the audience to specific action, and those messages meet the content criterion. AcSEC believes that that provision will result in the activities of some NPOs subject to IRC Section 501(c)4 (and some other entities, whose mission or goal is to educate the public) meeting the content criterion.

C.24. Paragraph 13c provides that one way that the audience criterion is met is if the entity is required to direct the management and general component of the activity to the particular audience. Further, as discussed in paragraph D.13, in *Discussion of Conclusions*, an audience that includes prior donors and is selected because the entity is required to send them certain information to comply with requirements of the Internal Revenue Service (IRS) is an example of an audience that is selected because the entity is required to direct the management and general component of the activity to that audience. Paragraph 14b provides that one way that the content criterion is met is if the activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity. However, footnote 9 to paragraph 14b provides that disclosures made when soliciting contributions to comply with requirements of states or other regulatory bodies are considered fund-raising activities, and are not considered management and general activities. AcSEC considered whether it is inconsistent to conclude both that (a) activities conducted to comply with requirements of regulatory bodies concerning contributions that have been received are management and general activities, and that (b) activities conducted to comply with requirements of regulatory bodies concerning soliciting contributions are fund-raising activities. AcSEC believes that those provisions are not inconsistent. AcSEC believes there is a distinction between (a) requirements that must be met as a result of receiving contributions and (b) requirements that must be met in order to solicit contributions. AcSEC believes that activities that are undertaken as a result of receiving contributions are management and general activities while activities that are undertaken in order to solicit contributions are fund-raising activities.

Incidental Activities

C.25. Many entities conduct fund-raising activities in conjunction with program or management and general activities that are incidental to such pro-

gram or management and general activities. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. Such efforts may be a practical and efficient means for entities to conduct activities, although the principal purpose of the activity may be to fulfill either fund-raising, program, or management and general functions. The exposure draft proposed that incidental activities need not be considered in applying this SOP. Some respondents disagreed with that guidance, while others commented that it was confusing. AcSEC continues to support that guidance. AcSEC believes that guidance is necessary to avoid requiring complex allocations in circumstances in which the criteria of purpose, audience, and content are met but the activity is overwhelmingly either fund raising, program, or management and general.

Allocation Methods

C.26. Respondents had various comments concerning allocation methods, including the following:

- The SOP should focus on allocation methods rather than on circumstances in which entities should allocate.
- The SOP should prescribe allocation methods.
- The approach taken in the SOP—discussing, rather than requiring or prohibiting allocation methods—is sound.
- Certain allocation methods should be prohibited.
- The SOP should set maximum allocation percentages.

AcSEC believes that no particular allocation method or methods are necessarily more desirable than other methods in all circumstances. Therefore, this SOP neither prescribes nor prohibits any particular allocation methods. AcSEC believes entities should apply the allocation methods that result in the most reasonable cost allocations for their activities. Appendix F of this SOP illustrates several allocation methods, any one of which may result in a reasonable or unreasonable allocation of costs in particular circumstances. The methods illustrated are not the only acceptable methods. However, AcSEC believes that the methods illustrated in this SOP are among those most likely to result in meaningful cost allocations.

C.27. Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, states in paragraph 7 that “the term *accounting principle* includes ‘not only accounting principles and practices but also the methods of applying them.’” APB Opinion 20 also states in paragraphs 15 and 16 that

... In the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle [*allocation method*] on the basis that it is preferable.

A change in cost allocation methodology may be a change in accounting principle for entities covered by this SOP. Accordingly, paragraph 16 of this SOP provides that the cost allocation methodology used should be applied consistently, given similar facts and circumstances.

Disclosures

C.28. Respondents made various comments concerning the required and encouraged disclosures, including recommendations for additional disclosures

and recommendations that certain disclosures be deleted. AcSEC was not persuaded that the costs of the other disclosures recommended by respondents are justified by their benefits. AcSEC believes that, with the exception of one disclosure, the disclosures prescribed by the exposure draft provide relevant information about the kinds of activities for which joint costs have been incurred and the manner in which those costs are reported in the financial statements. In considering disclosures proposed by the exposure draft about the allocation method, AcSEC observed that there are no requirements to disclose methods of allocating other expenses and questioned the utility of disclosing the allocation method in this circumstance. AcSEC concluded that the requirement to disclose the allocation method should be deleted.

C.29. Paragraph 19 encourages, but does not require, certain disclosures. AcSEC believes those disclosures provide useful information but that they should be encouraged rather than required because the costs of making them may not be justified by the benefits in all cases.

Effective Date

C.30. Some respondents commented that the effective date should be deferred. AcSEC believes that the accounting systems required to implement this SOP are already in place and that implementation should be relatively straightforward. However, AcSEC acknowledges that some entities may change their operations based on the reporting that would result from this SOP. Therefore, AcSEC concluded that this SOP should be effective for financial statements for years beginning on or after December 15, 1998.

Cost-Benefit

C.31. Some respondents commented that the guidance would increase record keeping costs. AcSEC believes that implementing this SOP will not significantly increase record keeping costs, which are primarily the costs of documenting reasons for undertaking joint activities. Further, AcSEC believes that the costs of making the disclosures required by this SOP should be minimal, because entities should already have the information that is required to be disclosed. AcSEC believes that implementing this SOP will result in more relevant, meaningful, and comparable financial reporting and that the cost of implementing this SOP will be justified by its benefits.

APPENDIX D

Discussion of Conclusions

Scope

D.1. This Statement of Position (SOP) applies only to costs of joint activities. It does not address allocations of costs in other circumstances.

Reporting Models and Related Requirements

D.2. Paragraph 26 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. Paragraph 13.30 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* provides that the financial statements of not-for-profit organizations (NPOs) should disclose the total fund-raising expenses.

D.3. Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, provides that governmental entities should not change their accounting and financial reporting to apply the provisions of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117. GASB Statement No. 29 permits governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities are permitted to change to the current governmental financial reporting model.

D.4. GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the "AICPA College Guide Model," encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements. (The other model, referred to as the "Governmental Model," is based on the pronouncements of the National Council on Governmental Accounting [NCGA] and the GASB.)

D.5. For state and local governmental entities, some are required to report expenses by function using the functional classifications of program, management and general, and fund raising. Other state and local governmental entities that report expenses or expenditures by function have a functional

structure that does not include fund raising, program, or management and general. Still other state and local governmental entities do not report expenses or expenditures by function. Examples of those various reporting requirements are as follows:

- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*, as well as those that follow SOP 78-10 and that receive significant amounts of contributions from the public, are required to report separately the costs of the fund-raising, program, and management and general functions.
- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, are required to report fund raising as part of the “institutional support” function.

D.6. As discussed in footnote 3 to paragraph 1 of this SOP, this SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. Rather, those functional classifications are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Entities that do not use the functional classifications of fund raising, program, and management and general should apply the guidance in this SOP for purposes of accounting for joint activities, using their reporting model. For example, some entities may conduct membership-development activities. As discussed in the Glossary of this SOP, if there are no significant benefits or duties connected with membership, the substance of the membership-development activities may, in fact, be fund raising. In such circumstances, the costs of those activities should be charged to fund raising. To the extent that member benefits are received, membership is an exchange transaction. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fund raising and the exchange transaction.

Assigning Costs of Joint Activities

D.7. Paragraph 7 provides: “If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity. . . .” For example, if the criteria are met, the costs of materials that accomplish program goals and that are unrelated to fund raising, such as the costs of a program-related pamphlet included in a joint activity, should be charged to program, while joint costs, such as postage, should be allocated between fund raising and program. However, if the pamphlet is used in fund-raising packets and the criteria are not met, the costs of the pamphlets used in the fund-raising packets, as well as the joint costs, should be charged to fund raising. (If some pamphlets are used in program activities that include no fund raising, the cost of the pamphlets used in those separate program activities that include no fund raising should be charged to program.)

Educational Activities

D.8. Some entities have missions that include educating the public (students) in areas other than causes. Paragraph 9 provides that, for those entities, educating the audience in areas other than causes or motivating the audience to engage in specific activities, such as attending a lecture or class, that will educate them in areas other than causes is considered a call for specific action by the recipients that will help accomplish the entity's mission. Educating the audience about causes or motivating the audience to engage in specific activities that will educate them about causes without educating them in other subjects is not considered a call for specific action by the audience that will help accomplish the entity's mission. An example of a lecture or class that will educate students in an area other than causes is a lecture on the nesting habits of the bald eagle, given by the Save the Bald Eagle Society, an NPO whose mission is to save the bald eagle from extinction and educate the public about the bald eagle. An example of a lecture or class that will address particular causes is a lecture by the Bald Eagle Society on the potential extinction of bald eagles and the need to raise contributions to prevent their extinction. For purposes of applying the guidance in this SOP, motivating the audience to attend a lecture on the nesting habits of the bald eagle is a call for specific action that will help accomplish the entity's mission. If the lecture merely addresses the potential extinction of bald eagles and the need to raise contributions to prevent their extinction, without addressing the nesting habits of the bald eagle, motivating the audience to attend the lecture is not considered a call for specific action by the recipient that will help accomplish the entity's mission.

D.9. AcSEC notes that most transactions in which a student attends a lecture or class are exchange transactions and are not joint activities. Such transactions are joint activities only if the activity includes fund raising.

Audience

D.10. Paragraph 12 provides that a rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for the program or management and general reasons specified in paragraph 13. Further, paragraph 12 provides that in determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for the reasons that may overcome that presumption. Some organizations conduct joint activities that are special events, such as symposia, dinners, dances, and theater parties, in which the attendee receives a direct benefit (for example, a meal or theater ticket) and for which the admission price includes a contribution. For example, it may cost \$500 to attend a dinner with a fair value of \$50. In that case, the audience is required to make a \$450 contribution in order to attend. In circumstances in which the audience is required to make a contribution to participate in a joint activity, such as attending a special event, the audience's ability or likelihood to contribute is a significant factor in its selection. Therefore, in circumstances in which the audience is required to make a contribution to participate in a joint activity, the extent to which the audience is selected for the program or management and general reasons in paragraph 13 must be overwhelmingly significant in order to rebut the presumption that the audience criterion is not met.

D.11. The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Some entities use lists compiled by others to reach new audiences. The source of such lists may indicate the purpose or purposes for which they were selected. For example, lists acquired from entities with similar or related programs are more likely to meet the audience criterion than are lists acquired from entities with dissimilar or unrelated programs. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected. For example, a list based on a consumer profile of those who buy environmentally friendly products may be useful to an entity whose mission addresses environmental concerns and could therefore indicate that the audience was selected for its ability to take action to assist the entity in meeting program goals. However, a list based on net worth would indicate that the audience was selected based on its ability or likelihood to contribute, unless there was a correlation between net worth and the program or management and general components of the activity.

D.12. Some audiences may be selected because they have an interest in or affinity to the program. For example, homeowners may have an interest in the homeless because they are sympathetic to the plight of the homeless. Nevertheless, including homeowners in the audience of a program activity to provide services to the homeless would not meet the audience criterion, because they do not have a need or reasonable potential for use of services to the homeless.

D.13. Paragraph 13c provides that the audience criterion is met if the entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component. An example of a joint activity in which the audience is selected because the entity is required to direct the management and general component of the joint activity to the particular audience is an activity in which the entity sends a written acknowledgment or other information to comply with requirements of the Internal Revenue Service to prior donors and includes a request for contributions. An example of a joint activity in which the audience is selected because the audience has reasonable potential for use of the management and general component is an activity in which the entity sends its annual report to prior donors and includes a request for contributions.

Content

D.14. Paragraph 14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. As discussed in the Glossary, the action should benefit the recipient or society. Examples of actions that benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or society (such as by addressing societal problems) include the following:

- a. Actions that benefit the recipient:
 - *Stop smoking.* Specific methods, instructions, references, and resources should be suggested.
 - *Do not use alcohol or drugs.* Specific methods, instructions, references, and resources should be suggested.
- b. Actions that benefit society:
 - *Write or call.* The party to communicate with and the subject matter to be communicated should be specified.

- *Complete and return the enclosed questionnaire.* The results of the questionnaire should help the entity achieve its mission. For example, if the entity discards the questionnaire, it does not help the entity achieve its mission.
- *Boycott.* The particular product or company to be boycotted should be specified.

D.15. Paragraph 14b provides that to meet the content criterion, management and general functions are required to fulfill one or more of the entity's management and general responsibilities through a component of the joint activity. Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. Paragraph 14, footnote 9, of this SOP provides that for purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities. Some examples of such disclosures include the following:

- Information filed with the attorney general concerning this charitable solicitation may be obtained from the attorney general of [*the state*] by calling 123-4567. Registration with the attorney general does not imply endorsement.
- A copy of the registration and financial information may be obtained from the Division of Consumer Services by calling toll-free, within [*the state*], 1-800-123-4567. Registration does not imply endorsement, approval, or recommendation by [*the state*].
- Information about the cost of postage and copying, and other information required to be filed under [*the state*] law, can be obtained by calling 123-4567.
- The organization's latest annual report can be obtained by calling 123-4567.

Allocation Methods

D.16. Paragraph 16 of this SOP states, "The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances." The allocation of joint costs should be based on the degree to which costs were incurred for the functions to which the costs are allocated (that is, program, management and general, or fund raising). For purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities, facts and circumstances that may be considered include factors related to the content and relative costs of the components of the activity. The audience should not be considered in determining whether the facts and circumstances are similar for purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities.

Practicability of Measuring Joint Costs

D.17. The Glossary of this SOP includes a definition of joint costs. Some costs, such as utilities, rent, and insurance, commonly referred to as indirect costs, may be joint costs. For example, the telephone bill for a department that, among other things, prepares materials that include both fund-raising and

program components may commonly be referred to as an indirect cost. Such telephone bills may also be joint costs. However, for some entities, it is impracticable to measure and allocate the portion of the costs that are joint costs. Considerations about which joint costs should be measured and allocated, such as considerations about materiality and the costs and benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

APPENDIX E

Illustrations of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted

Illustration 1

Facts

E.1. Entity A's mission is to prevent drug abuse. Entity A's annual report states that one of its objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

E.2. Entity A mails informational materials to the parents of all junior high school students explaining the prevalence and dangers of drug abuse. The materials encourage parents to counsel children about the dangers of drug abuse and inform them about how to detect drug abuse. The mailing includes a request for contributions. Entity A conducts other activities informing the public about the dangers of drug abuse and encouraging parents to counsel their children about drug abuse that do not include requests for contributions and that are conducted in different media. Entity A's executive director is involved in the development of the informational materials as well as the request for contributions. The executive director's annual compensation includes a significant bonus if total annual contributions exceed a predetermined amount.

Conclusion

E.3. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.4. The activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. (Although Entity A's executive director's annual compensation varies based on annual contributions, the executive director's compensation does not vary based on contributions raised for this discrete joint activity.) Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) the program component of this activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse) that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (b) performing such programs helps accomplish Entity A's mission. (Note that had Entity A conducted the activity using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions, the purpose criterion would have been met under paragraph 10*b*.)

E.5. The audience criterion is met because the audience (parents of junior high school students) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.6. The content criterion is met because the activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission (assisting parents in preventing their children from abusing drugs), and it explains the need for and benefits of the action (the prevalence and dangers of drug abuse).

Illustration 2

Facts

E.7. Entity B's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity B's objectives in fulfilling that mission is to inform the public about the effects and early warning signs of the disease and specific action that should be taken to prevent the disease.

E.8. Entity B maintains a list of its prior donors and sends them donor renewal mailings. The mailings include messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it. That information is also sent to a similar-sized audience but without the request for contributions. Also, Entity B believes that recent donors are more likely to contribute than nondonors or donors who have not contributed recently. Prior donors are deleted from the mailing list if they have not contributed to Entity B recently, and new donors are added to the list. There is no evidence of a correlation between recent contributions and participation in the program component of the activity. Also, the prior donors' need to use or reasonable potential for use of the messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it is an insignificant factor in their selection.

Conclusion

E.9. The purpose and content criteria are met. The audience criterion is not met.¹¹ All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, should be charged to fund raising.

E.10. The activity calls for specific action by the recipient (action that should be taken to prevent ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (to reduce the incidence of illness from the disease), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than

¹¹ Paragraph 7 of this SOP provides that all costs of joint activities, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should be charged to fund raising if any of the criteria of purpose, audience, or content are not met. Accordingly, if one or more criteria are not met, the other criteria need not be considered. However, the illustrations in this Appendix provide conclusions about whether each of the criteria would be met in circumstances in which one or more criteria are not met in order to provide further guidance.

the scale on which it is conducted with the request for contributions (a similar mailing is done without the request for contributions, to a similar-sized audience).

E.11. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is not overcome in this illustration. Although the audience has a need to use or reasonable potential for use of the program component, that was an insignificant factor in its selection.

E.12. The content criterion is met because the activity calls for specific action by the recipient (actions to prevent ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 3

Facts

E.13. Entity C's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity C's objectives in fulfilling that mission is to increase governmental funding for research about ABC disease.

E.14. Entity C maintains a list of its prior donors and its employees call them on the telephone reminding them of the effects of ABC disease, asking for contributions, and encouraging them to contact their elected officials to urge increased governmental funding for research about ABC disease. The callers are educated about ABC, do not otherwise perform fund-raising functions, and are not compensated or evaluated based on contributions raised. Entity C's research indicates that recent donors are likely to contact their elected officials about such funding while nonrecent donors are not. Prior donors are deleted from the calling list if they have not contributed to Entity C recently, and new donors are added to the list.

Conclusion

E.15. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.16. The activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the callers are educated about ABC and do not otherwise perform fund-raising functions), (b) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised), and (c) performing such programs helps accomplish Entity C's mission.

E.17. The audience criterion is met because the audience (recent donors) is selected based on its ability to assist Entity C in meeting the goals of the program component of the activity (recent donors are likely to contact their elected officials about such funding while nonrecent donors are not).

E.18. The content criterion is met because the activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 4

Facts

E.19. Entity D's mission is to improve the quality of life for senior citizens. One of Entity D's objectives included in that mission is to increase the physical activity of senior citizens. One of Entity D's programs to attain that objective is to send representatives to speak to groups about the importance of exercise and to conduct exercise classes.

E.20. Entity D mails a brochure on the importance of exercise that encourages exercise in later years to residents over the age of sixty-five in three zip code areas. The last two pages of the four-page brochure include a perforated contribution remittance form on which Entity D explains its program and makes an appeal for contributions. The content of the first two pages of the brochure is primarily educational; it explains how seniors can undertake a self-supervised exercise program and encourages them to undertake such a program. In addition, Entity D includes a second brochure on various exercise techniques that can be used by those undertaking an exercise program.

E.21. The brochures are distributed to educate people in this age group about the importance of exercising, to help them exercise properly, and to raise contributions for Entity D. These objectives are documented in a letter to the public relations firm that developed the brochures. The audience is selected based on age, without regard to ability to contribute. Entity D believes that most of the recipients would benefit from the information about exercise.

Conclusion

E.22. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the second brochure should be charged to program because all the costs of the brochure are identifiable with the program function.)

E.23. The activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) performing such programs helps accomplish Entity D's mission, and (b) the objectives of the program are documented in a letter to the public relations firm that developed the brochure.

E.24. The audience criterion is met because the audience (residents over sixty-five in certain zip codes) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.25. The content criterion is met because the activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mis-

sion (increasing the physical activity of senior citizens), and the need for and benefits of the action are clearly evident (explains the importance of exercising).

Illustration 5

Facts

E.26. The facts are the same as those in Illustration 4, except that Entity E employs a fund-raising consultant to develop the first brochure and pays that consultant 30 percent of contributions raised.

Conclusion

E.27. The content and audience criteria are met. The purpose criterion is not met, however, because a majority of compensation or fees for the fund-raising consultant varies based on contributions raised for this discrete joint activity (the fund-raising consultant is paid 30 percent of contributions raised). All costs should be charged to fund raising, including the costs of the second brochure and any other costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity.

Illustration 6

Facts

E.28. Entity F's mission is to protect the environment. One of Entity F's objectives included in that mission is to take action that will increase the portion of waste recycled by the public.

E.29. Entity F conducts a door-to-door canvass of a community that recycles a low portion of its waste. The purpose of the activity is to help increase recycling by educating the community about environmental problems created by not recycling, and to raise contributions. Based on the information communicated by the canvassers, the need for and benefits of the action are clearly evident. The ability or likelihood of the residents to contribute is not a basis for communities selected, and all neighborhoods in the geographic area are covered if their recycling falls below a predetermined rate. The canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns. The canvassers have not previously participated in fund-raising activities.

Conclusion

E.30. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.31. The activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the canvassers are selected from

individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns), and (b) performing such programs helps accomplish Entity F's mission (to protect the environment).

E.32. The audience criterion is met because the audience (neighborhoods whose recycling falls below a predetermined rate) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.33. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission (to protect the environment), and the need for and benefits of the action are clearly evident (increased recycling will help alleviate environmental problems).

Illustration 7

Facts

E.34. Entity G's mission is to provide summer camps for economically disadvantaged youths. Educating the families of ineligible youths about the camps is not one of the program objectives included in that mission.

E.35. Entity G conducts a door-to-door solicitation campaign for its camp programs. In the campaign, volunteers with canisters visit homes in middle-class neighborhoods to collect contributions. Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute. The volunteers explain the camp's programs, including why the disadvantaged children benefit from the program, and distribute leaflets to the residents regardless of whether they contribute to the camp. The leaflets describe the camp, its activities, who can attend, and the benefits to attendees. Requests for contributions are not included in the leaflets.

Conclusion

E.36. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.37. The activity does not include a call for specific action because it only educates the audience about causes (describing the camp, its activities, who can attend, and the benefits to attendees). Therefore, the purpose criterion is not met.

E.38. The audience criterion is not met, because the audience is selected based on its ability or likelihood to contribute, rather than based on (a) its need to use or reasonable potential for use of the action called for by the program component, or (b) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute.)

E.39. The content criterion is not met because the activity does not call for specific action by the recipient. (The content educates the audience about causes that the program is designed to address without calling for specific action.)

Illustration 8

Facts

E.40. Entity H's mission is to educate the public about lifesaving techniques in order to increase the number of lives saved. One of Entity H's objectives in fulfilling that mission, as stated in the minutes of the board's meetings, is to produce and show television broadcasts including information about lifesaving techniques.

E.41. Entity H conducts an annual national telethon to raise contributions and to reach the American public with lifesaving educational messages, such as summary instructions concerning dealing with certain life-threatening situations. Based on the information communicated by the messages, the need for and benefits of the action are clearly evident. The broadcast includes segments describing Entity H's services. Entity H broadcasts the telethon to the entire country, not merely to areas selected on the basis of giving potential or prior fund raising results. Also, Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising.

Conclusion

E.42. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.43. The activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish Entity H's mission (to save lives by educating the public), and (b) a similar program activity is conducted without the fund raising using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the appeal (Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising).

E.44. The audience criterion is met because the audience (a broad segment of the population) is selected based on its need to use or reasonable potential for use of the action called for by the program activity.

E.45. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission (to save lives by educating the public), and the need for and benefits of the action are clearly evident (saving lives is desirable).

Illustration 9

Facts

E.46. Entity I's mission is to provide food, clothing, and medical care to children in developing countries.

E.47. Entity I conducts television broadcasts in the United States that describe its programs, show the needy children, and end with appeals for contributions. Entity I's operating policies and internal management memoranda state that these programs are designed to educate the public about the

needs of children in developing countries and to raise contributions. The employees producing the programs are trained in audiovisual production and are familiar with Entity I's programs. Also, the executive producer is paid \$25,000 for this activity, with a \$5,000 bonus if the activity raises over \$1,000,000.

Conclusion

E.48. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.49. The activity does not include a call for specific action because it only educates the audience about causes (describing its programs and showing the needy children). Therefore, the purpose criterion is not met. (Also, note that if the factor in paragraph 10a were considered, it would not be determinative of whether the purpose criterion is met. Although the executive producer will be paid \$5,000 if the activity raises over \$1,000,000, that amount would not be a majority of the executive producer's total compensation for this activity, because \$5,000 would not be a majority of the executive producer's total compensation of \$30,000 for this activity. Also, note that if other evidence, such as the indicators in paragraph 11, were considered, the purpose criterion would not be met based on the other evidence. Although the qualifications and duties of the personnel performing the activity indicate that the employees producing the program are familiar with Entity I's programs, the facts that some, but less than a majority, of the executive producer's compensation varies based on contributions raised, and that the operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries [with no call for specific action by recipients] and to raise contributions, indicate that the purpose is fund raising.)

E.50. The audience criterion is not met because the audience is selected based on its ability or likelihood to contribute, rather than based on (a) its need to use or reasonable potential for use of the action called for by the program component, or (b) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (The audience is a broad segment of the population of a country that is not in need of or has no reasonable potential for use of the program activity.)

E.51. The content criterion is not met because the activity does not call for specific action by the recipient that will help accomplish the entity's mission. (The content educates the audience about the causes without calling for specific action.)

Illustration 10

Facts

E.52. Entity J is a university that distributes its annual report, which includes reports on mission accomplishments, to those who have made significant contributions over the previous year, its board of trustees, and its employees. The annual report is primarily prepared by management and general personnel, such as the accounting department and executive staff. The activity is coordinated by the public relations department. Internal management memoranda indicate that the purpose of the annual report is to report on how management discharged its stewardship responsibilities, including the univer-

sity's overall performance, goals, financial position, cash flows, and results of operations. Included in the package containing the annual report are requests for contributions and donor reply cards.

Conclusion

E.53. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.54. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) the employees performing the activity are not members of the fund-raising department and perform other non-fund-raising activities and (b) internal management memoranda indicate that the purpose of the annual report is to fulfill one of the university's management and general responsibilities.

E.55. The audience criterion is met because the audience is selected based on its reasonable potential for use of the management and general component. Although the activity is directed primarily at those who have previously made significant contributions, the audience was selected based on its presumed interest in Entity J's annual report (prior donors who have made significant contributions are likely to have an interest in matters discussed in the annual report).

E.56. The content criterion is met because the activity (distributing annual reports) fulfills one of the entity's management and general responsibilities (reporting concerning management's fulfillment of its stewardship function).

Illustration 11

Facts

E.57. Entity K is an NPO. In accordance with internal management memoranda documenting its policies requiring it to comply with Internal Revenue Service (IRS) regulations, it mails prior donors who have made quad pro quo payments in excess of \$75 documentation required by the IRS. The documentation is included on a perforated piece of paper. The information above the perforation line pertains to the documentation required by the IRS. The information below the perforation line includes a request for contributions and may be used as a donor reply card.

Conclusion

E.58. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the information below the perforation line are identifiable with fund raising and therefore should be charged to fund raising.)

E.59. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because internal management memoranda indicate that the purpose of the activity is to fulfill one of Entity K's management and general responsibilities.

E.60. The audience criterion is met because the entity is required to direct the management and general component of the activity to the particular audience. Although the activity is directed at those who have previously contributed, the audience was selected based on its need for the documentation.

E.61. The content criterion is met because the activity (sending documentation required by the IRS) fulfills one of the entity's management and general responsibilities (complying with IRS regulations).

Illustration 12

Facts

E.62. Entity L is an animal rights organization. It mails a package of material to individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own. In addition to donor response cards and return envelopes, the package includes (a) materials urging recipients to contact their legislators and urge the legislators to support legislation to protect those rights, and (b) postcards addressed to legislators urging support for legislation restricting the use of animal testing for cosmetic products. The mail campaign is part of an overall strategy that includes magazine advertisements and the distribution of similar materials at various community events, some of which are undertaken without fund-raising appeals. The advertising and community events reach audiences similar in size and demographics to the audience reached by the mailing.

Conclusion

E.63. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.64. The activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) the program component of this activity calls for specific action by the recipient that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (b) performing such programs helps accomplish Entity L's mission.

E.65. The audience criterion is met because the audience (individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own) is selected based on its ability to take action to assist the entity in meeting the goals of the program component of the activity.

E.66. The content criterion is met because the activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission (to protect animal rights), and the need for and benefits of the action are clearly evident (to protect animal rights).

Illustration 13

Facts

E.67. Entity M is a performing arts organization whose mission is to make the arts available to residents in its area. Entity M charges a fee for attending performances and sends advertisements, including subscription forms, for the performances to residents in its area. These advertisements include a return envelope with a request for contributions. Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received. In performing that evaluation, Entity M places more weight on the number of subscriptions sold than on the contributions received. Also, Entity M advertises the performances on local television and radio without a request for contributions but on a smaller scale than the mail advertising.

Conclusion

E.68. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.69. The activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10a or 10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) the entity measures program results and accomplishments of the joint activity and in evaluating the effectiveness of the activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received and places more weight on the number of subscriptions sold than on the contributions received), (b) it otherwise conducts the program activity without a request for contributions, and (c) performing such programs helps accomplish Entity M's mission (to make the arts available to residents in its area).

E.70. The audience criterion is met because the audience (a broad segment of the population in Entity M's area) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.71. The content criterion is met because the activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission (making the arts available to area residents), and the need for and benefits of the action are clearly evident (attending the performance is a positive cultural experience). (Note that the purchase of subscriptions is an exchange transaction and, therefore, is not a contribution.)

Illustration 14

Facts

E.72. Entity N is a university whose mission is to educate the public (students) in various academic pursuits. Entity N's political science department holds a special lecture series in which prominent world leaders speak about current events. The speakers command relatively high fees and, in order to cover costs and make a modest profit, the university sets a relatively expensive fee to attend. However, the tickets are priced at the fair value of the

lecture and no portion of the ticket purchase price is a contribution. Entity N advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. At some of the lectures, including the lecture being considered in this illustration, deans and other faculty members of Entity N solicit significant contributions from attendees. Other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions. Entity N's records indicate that historically 75 percent of the attendees have attended prior lectures. Of the 75 percent who have attended prior lectures, 15 percent have made prior contributions to Entity N. Of the 15 percent who have made prior contributions to Entity N, 5 percent have made contributions in response to solicitations made at the events. (Therefore, one-half of one percent of attendees make contributions in response to solicitations made at the events. However, those contributions are significant.) Overall, the audience's ability or likelihood to contribute is an insignificant factor in its selection. Entity N evaluates the effectiveness of the activity based on the number of tickets sold, as well as contributions received. In performing that evaluation, Entity N places more weight on the number of tickets sold than on the contributions received.

Conclusion

E.73. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.74. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions).

E.75. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is overcome in this illustration because the audience (those who have shown prior interest in the lecture series, prior donors, a broad segment of the population in Entity N's area, and those attending the lecture) is also selected for its reasonable potential for use of the program component (attending the lecture). Although the audience may make significant contributions, that was an insignificant factor in its selection.

E.76. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph 7 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.¹²)

¹² Paragraphs 13.17 to 13.22 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events.

Illustration 15

Facts

E.77. Entity O is a university whose mission is to educate the public (students) in various academic pursuits. Entity O's political science department holds a special lecture series in which prominent world leaders speak about current events. Admission is priced at \$250, which is above the \$50 fair value of the lecture and, therefore, \$200 of the admission price is a contribution. Therefore, the audience's likelihood to contribute to the entity is a significant factor in its selection. Entity O advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. Entity O presents similar lectures that are priced at the fair value of those lectures.

Conclusion

E.78. The purpose and content criteria are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, except for the costs of the direct donor benefit (the lecture), should be charged to fund raising.

E.79. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without including a contribution in the admission price.)

E.80. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute to the entity is not overcome in this illustration. The fact that the \$250 admission price includes a \$200 contribution leads to the conclusion that the audience's ability or likelihood to contribute is an overwhelmingly significant factor in its selection, whereas there is no evidence that the extent to which the audience is selected for its need to use or reasonable potential for use of the action called for by the program component (attending the lecture) is overwhelmingly significant.

E.81. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph 7 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.¹³)

¹³ Paragraphs 13.17 to 13.22 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events.

Illustration 16

Facts

E.82. Entity P's mission is to reduce the incidence of illness from ABC disease, which primarily afflicts people over sixty-five years of age. One of Entity P's objectives in fulfilling that mission is to have all persons over sixty-five screened for ABC disease.

E.83. Entity P rents space at events attended primarily by people over sixty-five years of age and conducts free screening for ABC disease. Entity P's employees, who are educated about ABC disease and screening procedures and do not otherwise perform fund-raising functions, educate interested parties about the effects of ABC disease and the ease and benefits of screening for it. Entity P also solicits contributions at the events. The effectiveness of the activity is evaluated primarily based on how many screening tests are performed, and only minimally based on contributions raised. The employees are not compensated or evaluated based on contributions raised.

Conclusion

E.84. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.85. The activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (a) a process exists to evaluate measured program results and accomplishments and in evaluating the effectiveness of the joint activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity P evaluates the effectiveness of the activity based on the number of screening tests conducted as well as contributions received and places more weight on the number of tests conducted than on the contributions received); (b) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the employees are educated about ABC disease and the testing procedures and do not otherwise perform fund-raising functions); (c) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised); and (d) performing such programs helps accomplish Entity P's mission (to prevent ABC disease).

E.86. The audience criterion is met because the audience (people over sixty-five years of age) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.87. The content criterion is met because the activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 17

Facts

E.88. Entity Q's mission is to provide cultural and educational television programming to residents in its area. Entity Q owns a public television station

and holds a membership drive in which it solicits new members. The drive is conducted by station employees and consists of solicitations that are shown during long breaks between the station's regularly scheduled programs. Entity Q's internal management memoranda state that these drives are designed to raise contributions. Entity Q evaluates the effectiveness of the activity based on the amount of contributions received. Entity Q shows the programs on a similar scale, without the request for contributions. The audience is members of the general public who watch the programs shown during the drive. Station member benefits are given to those who contribute and consist of tokens of appreciation with a nominal value.

Conclusion

E.89. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that there would be few, if any, joint costs. Costs associated with the fund-raising activities, such as costs of airtime, would be separately identifiable from costs of the program activities, such as licensing costs for a particular television program. Also, note that because no significant benefits or duties are associated with membership, member dues are contributions. Therefore, the substance of the membership-development activities is, in fact, fund raising.)

E.90. The activity calls for specific action by the recipient (watching the television program) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission, and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (Entity Q shows the television programs on a similar scale, without the request for contributions).

E.91. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute is overcome in this illustration because the audience (members of the general public who watch the television programs shown during the drive) is also selected for its reasonable potential for use of the program component (watching the television programs). Although the audience may make contributions, that was an insignificant factor in its selection.

E.92. The content criterion is met because the activity calls for specific action by the recipient (watching the television programs) that will help accomplish the entity's mission (providing cultural and educational television programming to residents in its area), and the need for and benefits of the action are clearly evident (watching the programs is a positive cultural and educational experience).

APPENDIX F

Illustrations of Allocation Methods

F.1. Some commonly used cost allocation methods follow.

Physical Units Method

F.2. Joint costs are allocated to materials and activities in proportion to the number of units of output that can be attributed to each of the materials and activities. Examples of units of output are lines, square inches, and physical content measures. This method assumes that the benefits received by the fund-raising, program, or management and general component of the materials or activity from the joint costs incurred are directly proportional to the lines, square inches, or other physical output measures attributed to each component of the activity. This method may result in an unreasonable allocation of joint costs if the units of output, for example, line counts, do not reflect the degree to which costs are incurred for the joint activity. Use of the physical units method may also result in an unreasonable allocation if the physical units cannot be clearly ascribed to fund raising, program, or management and general. For example, direct mail and telephone solicitations sometimes include content that is not identifiable with fund raising, program, or management and general; or the physical units of such content are inseparable.

Illustration

F.3. Assume a direct mail campaign is used to conduct programs of the entity and to solicit contributions to support the entity and its programs. Further, assume that the appeal meets the criteria for allocation of joint costs to more than one function.

F.4. The letter and reply card include a total of one hundred lines. Forty-five lines pertain to program because they include a call for action by the recipient that will help accomplish the entity's mission, while fifty-five lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs are allocated to program and 55 percent to fund-raising.

Relative Direct Cost Method

F.5. Joint costs are allocated to each of the components on the basis of their respective direct costs. Direct costs are those costs that are incurred in connection with the multipurpose materials or activity and that are specifically identifiable with a function (program, fund raising, or management and general). This method may result in an unreasonable allocation of joint costs if the joint costs of the materials and activity are not incurred in approximately the same proportion and for the same reasons as the direct costs of the materials and activity. For example, if a relatively costly booklet informing the reader about the entity's mission (including a call for action by the recipient that will help accomplish the entity's mission) is included with a relatively inexpensive fund-raising letter, the allocation of joint costs based on the cost of these pieces may be unreasonable, particularly if the booklet and letter weigh approximately the same and therefore contribute equally to the postage costs.

Illustration

F.6. The costs of a direct mail campaign that can be specifically identified with program services are the costs of separate program materials and a post-

card which calls for specific action by the recipient that will help accomplish the entity's mission. They total \$20,000. The direct costs of the fund-raising component of the direct mail campaign consist of the costs to develop and produce the fund-raising letter. They total \$80,000. Joint costs associated with the direct mail campaign total \$40,000 and would be allocated as follows under the relative direct cost method:

| | |
|--------------|---|
| Program | $\$20,000/\$100,000 \times \$40,000 = \$8,000$ |
| Fund raising | $\$80,000/\$100,000 \times \$40,000 = \$32,000$ |

Stand-Alone Joint-Cost-Allocation Method

F.7. Joint costs are allocated to each component of the activity based on a ratio that uses estimates of costs of items included in joint costs that would have been incurred had the components been conducted independently. The numerator of the ratio is the cost (of items included in joint costs) of conducting a single component independently; the denominator is the cost (of items included in joint costs) of conducting all components independently. This method assumes that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation. This method may result in an unreasonable allocation because it ignores the effect of each function, which is performed jointly with other functions, on other such functions. For example, the programmatic impact of a direct mail campaign or a telemarketing phone message may be significantly lessened when performed in conjunction with a fund-raising appeal.

Illustration

F.8. Assume that the joint costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of \$100,000. The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been \$90,000 for the program component and \$70,000 for the fund-raising component. Under the stand-alone joint-cost-allocation method, the \$100,000 in joint costs would be allocated as follows: $\$90,000/\$160,000 \times \$100,000 = \$56,250$ to program services and $\$70,000/\$160,000 \times \$100,000 = \$43,750$ to fund raising.

APPENDIX G

Illustrations of Disclosures

G.1. The disclosures discussed in paragraphs 18 and 19 are illustrated below. Alternative 1 reports the required and encouraged information in narrative format. Alternative 2 reports that information in tabular format, as well as information concerning joint costs incurred for each kind of activity by functional classification, which is neither required nor encouraged, but which is not prohibited.

Alternative 1

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included requests for contributions, as well as program and management and general components. Those activities included direct mail campaigns, special events, and a telethon. The costs of conducting those activities included a total of \$310,000 of joint costs, which are not specifically attributable to particular components of the activities (joint costs). *[Note to reader: The following sentence is encouraged but not required.]* Joint costs for each kind of activity were \$50,000, \$150,000, and \$110,000 respectively. These joint costs were allocated as follows:

| | |
|------------------------|------------------|
| Fund raising | \$180,000 |
| Program A | 80,000 |
| Program B | 40,000 |
| Management and general | 10,000 |
| Total | <u>\$310,000</u> |

Alternative 2

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included appeals for contributions and incurred joint costs of \$310,000. These activities included direct mail campaigns, special events, and a telethon. Joint costs were allocated as follows:

| | <u>Direct Mail</u> | <u>Special Events</u> | <u>Telethon</u> | <u>Total</u> |
|---------------------------|------------------------|---------------------------|------------------|------------------|
| Fund raising | \$40,000 | \$50,000 | \$90,000 | \$180,000 |
| Program A | 10,000 | 65,000 | 5,000 | 80,000 |
| Program B | | 25,000 | 15,000 | 40,000 |
| Management and general | | 10,000 | | 10,000 |
| Total | <u>\$50,000</u> | <u>\$150,000</u> | <u>\$110,000</u> | <u>\$310,000</u> |

[Note to reader: Shading is used to highlight information that is neither required nor encouraged, but which is not prohibited. However, entities may prefer to disclose it. Disclosing the total joint costs for each kind of activity (\$50,000, \$150,000, and \$110,000) is encouraged but not required.]

APPENDIX H

Contrast of Guidance in This SOP With the Guidance in SOP 87-2¹⁴

| <u>This SOP</u> | <u>SOP 87-2</u> |
|--|---|
| Applies to all entities that solicit contributions, including state and local governments. | Applied to entities that follow the AICPA Industry Audit Guide <i>Audits of Voluntary Health and Welfare Organizations</i> or SOP 78-10. (SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board Statement No. 29, <i>The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities</i> .) |
| Covers <i>all</i> costs of joint activities. (Costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event [for example, a meal], should be charged to fund raising unless the criteria in the SOP are met.) | Covers only joint costs of joint activities. |
| Criteria of purpose, audience, and content should all be met in order to charge costs of the activity to program or management and general. | Unclear concerning whether all criteria should be met in order to charge costs of the activity to program or management and general. |

¹⁴ In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*, which superseded Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the guidance in SOP 87-2 is incorporated into paragraphs 13.31 to 13.40 of the Guide. Also, *Not-for-Profit Organizations* superseded the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* and SOP 78-10. *Not-for-Profit Organizations* applies to all nongovernmental not-for-profit organizations other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. Therefore, incorporating the guidance in SOP 87-2 into *Not-for-Profit Organizations* broadened the scope of the guidance previously included in SOP 87-2 to all not-for-profit organizations other than those required to follow *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.31 to 13.40 of *Not-for-Profit Organizations*, except that the guidance in *Not-for-Profit Organizations* applies to all not-for-profit organizations other than those required to follow *Health Care Organizations*.

This SOP

Neither prescribes nor prohibits any allocation methods. Includes a discussion to help users determine whether an allocation is reasonable, and provides some illustrations.

Requires note disclosures about the types of activities for which joint costs have been incurred, amounts allocated during the period, and amounts allocated to each functional expense or expenditure category.

SOP 87-2

Neither prescribes nor prohibits any allocation methods. No illustrations are provided.

Requires less extensive note disclosures: total amount allocated during the period and amounts allocated to each functional expense category.

APPENDIX I

Effects on Other Guidance

I.1. For nongovernmental organizations, this Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* and paragraphs 13.31 to 13.40 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.

I.2. Also, this SOP amends the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* to clarify that costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund-raising. In particular, paragraphs 13.17, 13.19, and 13.20 of *Not-for-Profit Organizations* are amended as follows:

13.17 Some organizations conduct joint activities* that are special events, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.

* See the sections of this Guide that provide guidance concerning accounting for the costs of joint activities.

13.19 For example, assume that an organization has a special event that is an ongoing and major activity with a ticket price of \$100. Assume that the activity does not meet the audience criterion in SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, and, therefore, all costs of the activity, other than the direct donor benefits, should be reported as fund raising. The event includes a dinner that costs the organization \$25 and that has a fair value of \$30. (Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include (a) \$5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and (b) fund-raising costs of \$10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of \$200, program expenses of \$60, management and general expenses of \$20, and fund-raising expenses of \$20.

13.20 Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

Illustration 1

| | | |
|--|-------------|--------------|
| Changes in unrestricted net assets: | | |
| Contributions | | \$200 |
| Special event revenue | 100 | |
| Less: Costs of direct benefits to donors | <u>(25)</u> | |
| Net revenues from special events | | <u>75</u> |
| Contributions and net revenues from special events | | 275 |
| Other expenses: | | |
| Program | | 60 |
| Management and general | | 20 |
| Fund raising | | <u>35</u> |
| Total other expenses | | <u>115</u> |
| Increase in unrestricted net assets | | <u>\$160</u> |

Illustration 2

| | | |
|-------------------------------------|--|--------------|
| Changes in unrestricted net assets: | | |
| Revenues: | | |
| Contributions | | \$200 |
| Special event revenue | | <u>100</u> |
| Total revenues | | 300 |
| Expenses: | | |
| Program | | 60 |
| Costs of direct benefits to donors | | 25 |
| Management and general | | 20 |
| Fund raising | | <u>35</u> |
| Total expenses | | <u>140</u> |
| Increase in unrestricted net assets | | <u>\$160</u> |

Illustration 3

| | | |
|--|--|--------------|
| Changes in unrestricted net asset: | | |
| Contributions | | \$270 |
| Dinner sales | | 30 |
| Less: Costs of direct benefits to donors | | <u>(25)</u> |
| Gross profit on special events | | <u>5</u> |
| Contributions and net revenues from special events | | 275 |
| Other expenses: | | |
| Program | | 60 |
| Management and general | | 20 |
| Fund raising | | <u>35</u> |
| Total other expenses | | <u>115</u> |
| Increase in unrestricted net assets | | <u>\$160</u> |

1.3. For governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable Financial Accounting Standards Board [FASB] pronouncements issued through November 30, 1989, and by most applicable Governmental Accounting Standards Board [GASB] pronouncements) in conformity with GASB

Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, this SOP amends the principles—based on SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations*, as modified—that those entities apply. For governmental entities that have applied the accounting and financial reporting principles in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements in conformity with GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, this SOP amends the principles—based on *Audits of Colleges and Universities*, as amended and modified—that those entities apply. For other governmental organizations, this SOP amends the Audit and Accounting Guide *Audits of State and Local Governmental Units*.

Glossary

Activities. Activities are efforts to accomplish specific objectives. Some activities include producing and distributing materials. For example, if an entity undertakes a mass mailing that includes a letter and a pamphlet, producing and distributing the letter and pamphlet are part of the activity. Other activities may include no materials, such as an annual dinner or a radio commercial.

Compensation or fees. Reciprocal transfers of cash or other assets in exchange for services performed.

Contributions. Contributions are unconditional transfers of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

Costs of joint activities. Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund raising, program, management and general, and cost of sales. For example, some costs incurred for printing, paper, professional fees, and salaries to produce donor cards are not joint costs, although they may be incurred in connection with conducting joint activities.

Fund-raising activities. Fund-raising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

Help accomplish the entity's mission. Actions that help accomplish the entity's mission are actions that either benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or benefit society (by addressing societal problems).

Joint activity. A joint activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as program, management and general, membership development, or any other functional category used by the entity.

Joint costs. Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fund-raising and program components is a joint cost. Joint costs may include the costs of salaries, contract labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals.

Management and general activities. Management and general activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They

include oversight, business management, general recordkeeping, budgeting, financing, soliciting revenue from exchange transactions, such as government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. Disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other activities, are management and general activities, as are soliciting funds other than contributions, including exchange transactions (whether program-related or not).

Medium. A medium is a means of mass communication, such as direct mail, direct response advertising, or television.

Membership-development activities. Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising.

Program activities. Program activities are the activities that result in goods or services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others. Similarly, a health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others.

Appendix M

**Statement of
Position**

98-3

**Audits of States,
Local Governments, and
Not-for-Profit Organizations
Receiving Federal Awards**

March 17, 1998

Includes Guidance on the Single Audit Act Amendments of 1996 and Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 Revision)

Supersedes AICPA Statement of Position 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, and Part VII, “Audits of Federal Financial Assistance,” of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*

**Issued Under the Authority of
the Auditing Standards Board**

**American Institute of
Certified Public Accountants**

NOTE

This Statement of Position presents the recommendations of the AICPA Single Audit Working Group regarding the performance of audits in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 revision). This edition incorporates guidance contained in *Government Auditing Standards* (1994 revision) and Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

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Appendix C—Illustrative Schedules of Expenditures of Federal Awards

Appendix D—Illustrative Auditor's Reports

Appendix E—Illustrative Schedule of Findings and Questioned Costs

SUMMARY

This Statement of Position (SOP) provides guidance on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 revision). This SOP supersedes SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, and part VII, "Audits of Federal Financial Assistance," of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*.

In addition to providing an overview of the auditor's responsibilities in an audit of federal awards, this SOP—

- Describes the applicability of the Single Audit Act Amendments of 1996 and Circular A-133.
- Describes the auditor's responsibility for testing and reporting on the schedule of expenditures of federal awards.
- Describes the auditor's responsibility for considering internal control and for performing tests of compliance with applicable laws, regulations, and program compliance requirements under generally accepted auditing standards, *Government Auditing Standards*, and Circular A-133.
- Describes the auditor's responsibility for reporting and provides examples of the reports required by *Government Auditing Standards* and Circular A-133.
- Describes the auditor's responsibility for testing and reporting in a program-specific audit.

Further, this SOP incorporates guidance from the following documents:

- The Single Audit Act Amendments of 1996 and Circular A-133
- AICPA Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*
- *Government Auditing Standards* (1994 revision)
- The OMB Circular A-133 *Compliance Supplement* (June 1997 revision)

Chapter 1

INTRODUCTION AND OVERVIEW

Introduction

Purpose and Applicability

1.1 The purpose of this Statement of Position (SOP) is to provide auditors of states, local governments, and not-for-profit organizations (NPOs) that receive federal awards with a basic understanding of the procedures they should perform and of the reports they should issue for single audits and program-specific audits under—

- a. The Single Audit Act Amendments of 1996 (hereinafter referred to as the Single Audit Act or the Act).¹
- b. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*,² and the related *OMB Circular A-133 Compliance Supplement*.
- c. The standards applicable to financial audits contained in the 1994 revision of *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States of the U.S. General Accounting Office (GAO).³ These standards incorporate the fieldwork and reporting standards of generally accepted auditing standards (GAAS)⁴ issued by the American Institute of Certified Public Accountants (AICPA).

1.2 This SOP provides guidance about financial and compliance auditing standards and requirements related to single audits (chapters 1 through 10) and program-specific audits (chapter 11) for entities (also referred to as auditees) subject to the Single Audit Act and Circular A-133. Applicable standards and requirements are promulgated by the OMB, GAO, and AICPA. This SOP also provides guidance on applicable auditing standards and requirements established by those organizations to assist auditors in planning, performing, and reporting on single audits and program-specific audits in ac-

¹ The Single Audit Act Amendments of 1996 (Public Law 104-156) was enacted into law in July 1996 and replaced the Single Audit Act of 1984. A reprint of the Single Audit Act Amendments of 1996 is included in appendix A of this SOP.

² Circular A-133 (as revised on June 30, 1997), is reprinted in appendix B of this SOP.

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

⁴ GAAS requirements are discussed in this SOP to the extent necessary to explain the related requirements of *Government Auditing Standards*. Auditors should refer to relevant AICPA Statements on Auditing Standards and also related Audit and Accounting Guides such as *Not-for-Profit Organizations*, *Health Care Organizations*, and *Audits of State and Local Governmental Units* for additional information on GAAS requirements.

cordance with those standards and requirements, and includes illustrative audit reports. Since Circular A-133 is the federal policy guidance to which auditors are held in performing single audits, this SOP will primarily focus on its requirements.

1.3 This SOP is organized by chapters in which the important considerations in performing single audits and program-specific audits are discussed (see table of contents).

1.4 This SOP is not a complete manual of procedures, nor should it supplant the auditor's judgment about the audit work required in particular situations. Because of the variety of federal, state, and local financial assistance programs and the complexity of the regulations that govern them, the procedures included in this SOP cannot cover all the circumstances or conditions that would be encountered in the audits of every entity. The auditor should use professional judgment to tailor his or her procedures to meet the conditions of the particular engagement, so that the audit objectives may be achieved.

1.5 Auditors should be aware that certain states have imposed additional audit requirements related to state or local financial assistance. The guidance in this SOP does not extend to individual state requirements (except for the guidance in paragraphs 3.47, 3.48, and 6.71). Furthermore, pass-through entities may impose additional audit requirements on their subrecipients related to the financial assistance passed through. The guidance in this SOP also does not extend to those requirements.

Definitions

1.6 The terms used in this SOP are intended to be consistent with the definitions in the Single Audit Act and Circular A-133. Similarly, the term *not-for-profit organization* as used in this SOP is consistent with the definition of the term *non-profit organization* in Circular A-133 (see appendix B) and includes not-for-profit institutions of higher education, hospitals, and other health care providers.

Effective Dates

1.7 The requirements of the Single Audit Act and Circular A-133 are effective for audits of fiscal years beginning after June 30, 1996. This SOP also includes auditing guidance through AICPA Statement on Auditing Standards (SAS) No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333). The effective dates of this auditing guidance should be applied as provided for in the related literature. This SOP does not change the effective dates of the auditing standards, the act, and Circular A-133. The remaining provisions of this SOP are applicable to audits of fiscal years beginning after June 30, 1996, in which the related fieldwork commences on or after March 1, 1998. Earlier application is encouraged.

Objectives of a Single Audit

1.8 A single audit has two main objectives: (a) an audit of the entity's financial statements and the reporting on the schedule of expenditures of federal awards in relation to those financial statements and (b) a compliance audit of federal awards expended during the fiscal year. Each of these results in the preparation and issuance of certain audit reports (see paragraph 2.7 for a more detailed description of the audit objectives).

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

1.9 The financial statement audit required by Circular A-133 is performed in accordance with the standards applicable to financial audits contained in *Government Auditing Standards* and GAAS, and it results in the auditor reporting on the entity's financial statements and on the scope of the auditor's testing of compliance and internal control over financial reporting and presents the results of those tests. The primary sources of guidance and standards regarding financial statement audits are the AICPA Statements on Auditing Standards (SASs), particularly SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801); *Government Auditing Standards*; and the following AICPA Audit and Accounting Guides, as applicable: *Not-for-Profit Organizations*, *Audits of State and Local Governmental Units*, *Health Care Organizations*, and *Audits of Colleges and Universities*.⁵ Refer to chapter 4 for a more detailed discussion of financial statement audit considerations under Circular A-133. Guidance on reporting on the schedule of expenditures of federal awards is provided in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). Refer to chapter 5 for a more detailed discussion of the schedule of expenditures of federal awards.

Compliance Audit of Federal Awards

1.10 Under Circular A-133, the auditor has additional testing and reporting responsibilities for compliance, as well as internal control over compliance, beyond a financial statement audit performed in accordance with *Government Auditing Standards* and GAAS. The compliance audit of federal awards expended during the fiscal year provides a basis for issuing an additional report on compliance related to major programs and on internal control over compliance.⁶ The various types of federal awards and payment methods are described in paragraphs 1.17 through 1.23. Compliance auditing considerations applicable to major programs and internal control over compliance are discussed in chapters 6 and 8. Reporting is discussed in chapter 10.

Adherence to Professional Standards and Requirements

1.11 The auditor should be aware that AICPA Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits*, states that when an auditor undertakes an audit of government grants or recipients of government monies and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, he or she is obligated to follow these standards or guidelines in addition to GAAS. Failure to do so is an act discreditable to the profession and a violation of rule 501 of the AICPA Code of Professional Conduct, unless it is disclosed in the auditor's report that these rules were not followed and the reasons for doing so are given.

⁵ Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

⁶ A major program is defined in Circular A-133. See the discussion of the determination of major programs in chapter 7.

Relationship of the Single Audit Act, Circular A-133, Government Auditing Standards, and GAAS

1.12 The Single Audit Act Amendments of 1996 were enacted to streamline and improve the effectiveness of audits of federal awards and to reduce the audit burden on states, local governments, and NPOs. Those goals were achieved, in part, by increasing the dollar threshold for requiring a single audit to \$300,000 in federal awards expended from \$25,000 in federal awards received and introducing a risk-based approach for determining which federal programs are to be considered major programs (see paragraph 2.2 for a further discussion of the audit threshold). The Single Audit Act requires single audits and program-specific audits of federal awards to be performed in accordance with *Government Auditing Standards*,⁷ and gives the Director of OMB the authority to develop government-wide guidelines and policy on performing audits to comply with the Act. The OMB established audit guidelines and policy in Circular A-133, which was revised and issued June 30, 1997,⁸ and establishes a uniform system of auditing states, local governments, and NPOs that expend federal awards. (Chapter 2 provides an overview of Single Audit Act and Circular A-133 requirements.) Circular A-133 has been adopted in regulation by individual federal departments and agencies.

1.13 In performing audits in accordance with the standards applicable to financial audits contained in *Government Auditing Standards*, the auditor assumes certain responsibilities beyond those of audits performed in accordance with GAAS.⁹ *Government Auditing Standards* includes general standards, incorporates the fieldwork and reporting standards under GAAS, and includes additional fieldwork and reporting standards. *Government Auditing Standards* includes additional standards in such areas as quality control reviews, continuing professional education, working papers, and audit follow-up (see paragraphs 3.8 through 3.21 for a detailed discussion of the additional standards). The reporting responsibilities in *Government Auditing Standards* require additional reporting on compliance and on internal control over financial reporting (see paragraphs 3.19 through 3.21, 10.15, and 10.16 for a detailed discussion of the reporting requirements).

⁷ *Government Auditing Standards* includes standards for financial audits as well as for performance audits. The references to *Government Auditing Standards* in this SOP encompass only the standards applicable to financial audits and not the performance audit standards (see footnote 3). However, *Government Auditing Standards* states that auditors should follow, as appropriate, the report contents standards for objectives, scope, and methodology; audit results; the view of responsible officials; and its report presentation standards. A discussion of these standards is contained in the performance auditing standards in chapter 7 of *Government Auditing Standards* (see paragraph 10.21).

⁸ The June 30, 1997, revision to Circular A-133 superseded OMB Circular A-128, *Audits of State and Local Governments*, and all previous versions of Circular A-133.

⁹ Paragraphs 21 through 23 of SAS No. 74 describe the auditor's responsibility when he or she has been engaged to perform an audit in accordance with GAAS and becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. In such a situation, SAS No. 74 requires that the auditor communicate to management and the audit committee, or to others with equivalent authority or responsibility, that an audit in accordance with GAAS alone may not satisfy the relevant legal, regulatory, or contractual requirements. That communication may be oral or written. However, 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 a 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 in relation to the guidance in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), and SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

Compliance Testing

1.14 Table 1.1 presents the relationship among the compliance testing requirements of GAAS, Government Auditing Standards, the Single Audit Act, and Circular A-133. Compliance testing requirements are discussed in detail in chapter 6. SAS No. 74 provides general guidance on the auditor's responsibility for compliance auditing under GAAS, *Government Auditing Standards*, and federal audit requirements. In SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit is described. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), as amended by SAS No. 82, describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors.

Internal Control Consideration

1.15 Table 1.2 presents the relationship among the requirements to consider internal control under GAAS, *Government Auditing Standards*, the Single Audit Act, and Circular A-133. Internal control requirements are discussed in detail in chapters 4 and 8.

Table 1.1

Compliance Testing

| | <i>Fieldwork Responsibilities</i> | <i>Reporting Responsibilities</i> |
|---------------------------------------|---|---|
| Generally accepted auditing standards | Design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 54, <i>Illegal Acts by Clients</i> , as described in SAS No. 74, <i>Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance</i> , and to provide reasonable assurance about whether the financial statements are free of material misstatements (whether caused by error or fraud), as described in SAS No. 82, <i>Consideration of Fraud in a Financial Statement Audit</i> , and SAS No. 47, <i>Audit Risk and Materiality in Conducting an Audit</i> . | Requires the auditor to adequately inform the audit committee or others with equivalent authority and responsibility about any illegal acts that the auditor becomes aware of during the audit unless they are clearly inconsequential. Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported directly to the audit committee. When the auditor identifies fraud risk factors that have continuing control implications, the auditor should communicate those factors that are considered reportable conditions to senior management and the audit committee. See SAS No. 82, paragraphs 38 through 40, for an additional discussion of the reporting requirements of SAS No. 82. |
| <i>Government Auditing Standards</i> | Same responsibilities as required by GAAS, but <i>Government Auditing Standards</i> specifically states that auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts. | Requires a written report describing the scope of the auditor's testing of compliance with laws and regulations and presenting the results of those tests (additional details on the reporting responsibilities are included in paragraphs 10.15, 10.16, and 10.21 through 10.25). |
| Single Audit Act and Circular A-133 | Determine whether the entity complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that have a direct and material effect on each major program. | Requires the auditor to express an opinion on whether the entity complied with laws, regulations, and with the provisions of contracts or grant agreements which could have a direct and material effect on each major program and, where applicable, refer to a separate schedule of findings and questioned costs. |

Table 1.2

Internal Control Responsibilities

| | <i>Fieldwork Responsibilities</i> | <i>Reporting Responsibilities</i> |
|---------------------------------------|---|---|
| Generally accepted auditing standards | Obtain an understanding of internal control over financial reporting sufficient to plan the audit by performing procedures to understand both the design of controls relevant to an audit of financial statements and whether they have been placed in operation, and assess control risk, in accordance with SAS No. 55, <i>Consideration of Internal Control in a Financial Statement Audit</i> , as amended by SAS No. 78, <i>Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55</i> . | Requires the auditor to communicate, either orally or in writing, any reportable conditions as described in SAS No. 60, <i>Communication of Internal Control Related Matters Noted in an Audit</i> . |
| <i>Government Auditing Standards</i> | Same responsibilities as GAAS. <i>Government Auditing Standards</i> provides additional guidance on the control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessments. | Requires a written report describing the scope of the auditor's testing of internal control and presenting the results of those tests. Also requires separate identification and written communication of all reportable conditions, including those reportable conditions that are individually or cumulatively material weaknesses. |
| Single Audit Act and Circular A-133 | With regard to internal control over compliance, the auditor is required to do the following (in addition to the requirements of <i>Government Auditing Standards</i>): (1) perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs, (2) plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program, and (3) perform tests of internal control (unless the internal control is likely to be ineffective in preventing or detecting noncompliance). | Requires a written report on internal control over major programs describing the scope of testing internal control and the results of the tests, and, where applicable, referring to a separate schedule of findings and questioned costs. |

* Circular A-133 requires the auditor to plan the audit to support a low assessed level of control risk for major programs; however, it does not actually require the achievement of a low assessed level of control risk. See paragraphs 8.16 through 8.22.

Reporting

1.16 A matrix depicting the recommended auditor's reports in a single audit required by GAAS, *Government Auditing Standards*, and Circular A-133 appears in table 1.3. Reporting is discussed in detail in chapter 10.

Table 1.3**Recommended Reporting in Single Audits**

| <i>Report</i> | <i>Required by—</i> | | |
|---|---------------------|--------------------------------------|-----------------------|
| | <i>GAAS</i> | <i>Government Auditing Standards</i> | <i>Circular A-133</i> |
| Opinion (or disclaimer of opinion) on financial statements and supplementary schedule of expenditures of federal awards | X | X | X |
| Report on compliance and on internal control over financial reporting based on an audit of financial statements | | X | X |
| Report on compliance and internal control over compliance applicable to each major program (this report must include an opinion [or disclaimer of opinion] on compliance) | | | X |
| Schedule of findings and questioned costs | | | X |

Types of Federal Awards and Payment Methods*Definition of Federal Awards*

1.17 Circular A-133 defines federal awards as *federal financial assistance* and *federal cost-reimbursement contracts* that auditees receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts (under grants or contracts) used to buy goods or services from vendors. See paragraph 2.15 for a discussion of subrecipient and vendor determinations.

Federal Financial Assistance—Classification and Types

1.18 Federal sponsors have classified federal financial assistance into program categories in the *Catalog of Federal Domestic Assistance* (CFDA), published by the Government Printing Office. Circular A-133 defines federal programs as all federal awards under the same CFDA number. Certain clusters of federal programs should be treated as one program for determining major programs. Research and development, student financial aid, and certain other programs are defined as a cluster in the *OMB Circular A-133 Compliance Supplement* because they are closely related and share common compliance requirements (see paragraphs 1.26 through 1.28 and chapters 2 and 6 for additional discussion of the *Compliance Supplement*).

1.19 Sometimes state governments combine funding from different federal awards in providing assistance to their subrecipients when the awards are

closely related programs and share common compliance requirements. In this case, Circular A-133 states that the state may require the subrecipient to treat the combined federal awards as a cluster of programs. See paragraph 2.18 for further information.

1.20 There are over 1,000 individual grant programs and several distinct types of federal award payment methods. Many of these programs are described in the CFDA; however, certain programs may not be included. For example, contracts may not be listed in the CFDA. Circular A-133 states that when a CFDA number is not assigned, all federal awards from the same agency that are made for the same purpose should be combined and considered one program.

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

- *Formula grants.* For activities of a continuing nature not confined to a specific project, allocations of money to nonfederal entities are made in accordance with a distribution formula prescribed by law or administrative regulation. One example is the Department of Agriculture's award to land-grant universities for cooperative extension services. Another example is the Department of Justice's award to state and local governments for drug control and systems improvement.
- *Project grants.* These involve the funding (for fixed or known periods) of specific projects, or the delivery of specific services or products, without liability for damages resulting from a failure to perform. Project grants include fellowships, scholarships, research grants, training grants, traineeships, experimental and demonstration grants, evaluation grants, planning grants, technical assistance grants, construction grants, and unsolicited contractual agreements.
- *Direct payments for specific use.* Financial assistance is provided by the federal government directly to individuals, private firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the assistance upon the recipient's performance. These do not include solicited contracts for the procurement of goods and services for the federal government.
- *Direct payments with unrestricted use.* Financial assistance is provided by the federal government directly to beneficiaries who satisfy federal eligibility requirements with no restrictions imposed on how the money is spent. Included are payments under retirement, pension, and compensation programs.
- *Direct loans.* Financial assistance is provided through the lending of federal monies for a specific period of time, with a reasonable expectation of repayment. Such loans may or may not require the payment of interest.
- *Guaranteed insured loans.* For these programs, the federal government makes an arrangement to indemnify a lender against part of any defaults by those responsible for the repayment of loans.
- *Insurance.* Financial assistance is provided to assure reimbursement for losses sustained under specified conditions. Coverage may be provided directly by the federal government or through a private carrier, and may or may not involve the payment of premiums.
- *Sale, exchange, or donation of property and goods.* These programs provide for the sale, exchange, or donation of federal real property, per-

sonal property, commodities, and other goods, including land, buildings, equipment, food, and drugs. This does not include the loan of, use of, or access to federal facilities or property.

Federal Cost-Reimbursement Contracts

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

1.23 Awards may be provided to entities through reimbursement arrangements in which recipients bill grantors for costs as incurred. Some programs provide for advance payments. Other programs permit entities to draw cash as grant expenditures are incurred.

Determining the Scope of a Single Audit

1.24 The scope of the auditor's work in an audit in accordance with Circular A-133 is determined by (a) the level of assessed risk associated with the federal programs and whether they are identified as a major program and (b) the compliance requirements applicable to those programs.

Risk-Based Approach

1.25 The audit scope depends on whether the federal awards expended are identified as relating to major programs. Circular A-133 places the responsibility for identifying major programs on the auditor, and it provides criteria for the auditor to use in applying a risk-based approach. The auditor's determination of the programs to be audited is based on an overall evaluation of the risk of noncompliance occurring which could be material to the individual federal programs. In evaluating risk, the auditor considers, among other things, the current and prior audit experience with the auditee, oversight by the federal agencies and pass-through entities, and the inherent risk of the federal programs. Chapter 7 includes a detailed discussion of applying the risk-based approach to determining major programs.

Compliance Requirements

1.26 Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The term *compliance requirements* refers to the laws, regulations, and provisions of contracts and grant agreements that an auditor should consider in making this determination (see chapter 6 for a more detailed discussion).

1.27 The principal compliance requirements and suggested audit procedures for the largest federal programs are included in the *Compliance Supplement*.¹⁰

1.28 With regard to federal programs included in the *Compliance Supplement*, the auditor should follow the guidance contained in the *Compliance Supplement* for testing compliance requirements. The auditor should be aware

¹⁰ A copy of the *Compliance Supplement* may be obtained from EOP Publications, Office of Administration, 2200 NEOB, Washington, D.C. 20503; (202) 395-7332. It is also available from the OMB's home page at <http://www.whitehouse.gov/WH/EOP/omb>, under the captions "OMB Documents," and then "Grants Management," and the Office of Inspector General home page at <http://www.ignet.gov>.

that compliance requirements may change over time. Thus, the auditor should also inquire of the auditee and review the provisions of grant agreements to determine whether compliance requirements reflected in the *Compliance Supplement* have changed. If there have been changes, the auditor should follow the provisions of the *Compliance Supplement* as modified by the changes (see chapters 2 and 6 for a more detailed discussion of the *Compliance Supplement*). For programs not listed in the *Compliance Supplement*, the auditor should follow *Compliance Supplement* part 7 “Guidance for Auditing Programs Not Included in This Compliance Supplement,” which instructs the auditor to use the types of compliance requirements (for example, cash management, reporting, allowable costs/cost principles, activities allowed or unallowed, eligibility, and matching, level of effort, and earmarking) contained in the *Compliance Supplement* as guidance for identifying the types of compliance requirements to test, and to determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.

1.29 In addition, some agencies have developed audit guides or supplements related to their programs. Auditors should consult with the applicable federal agency to determine the availability of agency-prepared supplements or audit guides. This guidance, where applicable, may be obtained from the Office of Inspector General of the appropriate federal agency.

The Auditor’s Responsibilities in Single Audits— An Overview

Compliance With Laws and Regulations

1.30 In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to provide an opinion on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The auditor’s responsibility for compliance auditing is discussed further in chapter 6. The required reporting and the schedule of findings and questioned costs are discussed in chapter 10.

Internal Control Over Compliance

Planning

1.31 In a single audit, the auditor must obtain an understanding of the design and operation of internal control over compliance with requirements that could have a direct and material effect on a major program. The auditor’s work in this area is in addition to the consideration of internal control over financial reporting that is part of a financial statement audit. Specifically, the auditor must obtain an understanding of internal control over compliance that is sufficient to plan the audit to support a low assessed level of control risk for major programs.

Testing

1.32 Circular A-133 also requires auditors to test internal control over compliance by implementing the planned tests. Evidence gained from the tests

of controls relevant to compliance requirements may be used by the auditor to determine the nature, timing, and extent of the testing required to express an opinion on compliance with requirements applicable to major programs. The requirements and auditor responsibilities associated with internal control over compliance in a single audit are discussed in chapter 8.

Chapter 2

OVERVIEW OF THE SINGLE AUDIT ACT, CIRCULAR A-133, AND THE OMB CIRCULAR A-133 COMPLIANCE SUPPLEMENT

2.1 This chapter provides an overview of the significant requirements and guidance in the Single Audit Act, Circular A-133, and the *OMB Circular A-133 Compliance Supplement*. Because Circular A-133 incorporates the requirements of the Single Audit Act and provides additional guidance, the requirements of the Act and Circular A-133 are discussed together as one in this SOP. Accordingly, references to Circular A-133 also include the requirements of the Single Audit Act. Auditors should refer to the Single Audit Act, Circular A-133, and the *Compliance Supplement* for a complete understanding of the requirements. The Single Audit Act and Circular A-133 are reprinted in appendixes A and B, respectively. See footnote 10 of chapter 1 for instructions on how to obtain a copy of the *Compliance Supplement*.

Single Audit Act and Circular A-133 Requirements

General Audit Requirements

Audit Threshold

2.2 Entities that expend \$300,000 or more in a fiscal year in federal awards are subject to the Single Audit Act and Circular A-133 and, therefore, must have a single or program-specific audit. Entities expending awards under only one program (excluding research and development [R&D]) may elect to have a program-specific audit if the program's laws, regulations, or grant agreements do not require a financial statement audit. A program-specific audit may not be elected for R&D unless (a) all expenditures are for awards received from the same federal agency or from the same federal agency and the same pass-through entity and (b) advance approval is obtained (see chapter 11 for additional guidance on program-specific audits). Entities that expend less than \$300,000 in a fiscal year in federal awards are exempt from audit requirements in the Single Audit Act and Circular A-133. However, those entities are not exempt from other federal requirements (including those to maintain records) concerning federal awards provided to the entity. Such records must be available for review or audit by appropriate officials of a federal agency, pass-through entity, and the GAO. The Single Audit Act provides that, every two years, the OMB may review the amount for requiring audits and may raise the dollar threshold amount above \$300,000.

Applicable Standards and Covered Entity

2.3 Circular A-133 audits must be conducted by an independent auditor¹ in accordance with *Government Auditing Standards*, and they must cover the entire operations of the auditee or, at the option of the auditee, the audit may include a series of audits that cover departments, agencies, and other or-

¹ The Single Audit Act defines "independent auditor" as (a) an external state or local government auditor who meets the independence standards included in *Government Auditing Standards* or (b) a public accountant who meets such independence standards.

ganizational units that expended or otherwise administered federal awards during the fiscal year, provided that each audit encompasses the financial statements and the schedule of expenditures of federal awards for each such department, agency, and organizational unit (see paragraph 3.25 for a more detailed discussion of this requirement).

Relation to Other Audit Requirements

2.4 A Circular A-133 audit is deemed to be in lieu of any financial audit of federal awards that an entity is required to undergo under any other federal law or regulation. However, notwithstanding a Circular A-133 audit, a federal agency (including its Inspectors General or GAO) may conduct or arrange for additional audits (for example, financial audits, performance audits, evaluations, inspections, or reviews) that are necessary to carry out their responsibilities under federal law or regulation. Any additional audits should be planned and performed in such a way as to build upon work performed by auditors. A federal agency that conducts or contracts for additional audits must arrange for funding the full cost of such additional audits. See paragraph 2.19 for a discussion of the federal agency option to request certain programs to be audited as major programs.

Frequency of Audits

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

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

Non-U.S.-Based Entities

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

Audit Objectives and Reporting Matters

Audit Objectives

2.7 In a single audit, the auditor's objectives are to—

- Determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally ac-

cepted accounting principles. (Note that Circular A-133 does not prescribe the basis of accounting that must be used by auditees to prepare their financial statements. See paragraphs 4.2 and 4.3 for a further discussion.)

- Determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.
- Obtain an understanding of the internal control over compliance for each major program, assess the control risk, and perform tests of those controls unless the controls are deemed to be ineffective (the auditor must perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for each major program).
- Determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that may have a direct and material effect on each of its major programs.

Audit Reports

2.8 Section 505 of Circular A-133 includes specific auditor reporting requirements. Those requirements are summarized in paragraph 10.3. See paragraphs 10.8 through 10.10 for a description of the reports illustrated in this SOP to meet the reporting requirements of Circular A-133.

Timing of the Submission of the Report

2.9 The audit should be completed and the data collection form and the reporting package (described in paragraphs 2.24, 2.25, 10.6, and 10.7), including the auditor's reports, should be submitted by the auditee (to the federal clearinghouse designated by the OMB) within the earlier of thirty days after receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit (see paragraphs 10.74 through 10.79 for a further discussion).²

Audit Follow-Up

2.10 Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. (See paragraphs 3.24 and 6.61 through 6.67 for a further discussion of the auditor's responsibility for audit follow-up.)

Auditor Selection and Audit Costs

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

2.11 Circular A-133 also establishes guidance on the procurement of audit services, as well as guidance on the restrictions on the selection of audi-

² Auditors should note that there is a delayed implementation for this requirement. Therefore, for fiscal years beginning on or before June 30, 1998, the audit must be completed and the data collection form and the reporting package should be submitted (to the federal clearinghouse designated by the OMB) within the earlier of thirty days after receipt of the auditor's report or thirteen months after the end of the audit period.

tors who also prepare the indirect cost proposal or cost allocation plan. Auditors who prepare the indirect cost proposal or cost allocation plan may not also be selected to perform the Circular A-133 audit if the indirect costs recovered by the auditee during the prior year exceeded \$1 million.³ See paragraph 3.52 for additional information on this restriction.

Audit Costs

2.12 Circular A-133 provides guidance on whether the charging of audit costs to federal awards may be allowed. Unless prohibited by law, the costs of Circular A-133 audits are allowable charges to federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB Cost Principles Circulars, the Federal Acquisition Regulation, or other applicable cost principles or regulations. The costs of single audits that are not conducted in accordance with Circular A-133 are unallowable. Furthermore, audit costs associated with Circular A-133 audits of entities that expend less than \$300,000 per year in federal awards are unallowable. However, this provision does not prohibit pass-through entities from charging federal awards for the costs of limited-scope audits to monitor its subrecipients. See paragraph 9.32 for further information on the allowability of audit costs associated with limited-scope audits. With regard to the amount of audit cost that can be charged to a federal award, the Single Audit Act states that in the absence of documentation demonstrating a higher actual cost, the percentage of the cost of single audits charged to federal awards by an entity may not exceed the ratio of total federal awards expended to the entity's total expenditures for the fiscal year.

Basis for Determining When Federal Awards Are Expended

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

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

2.14 Circular A-133 provides specific guidance on the basis of determining federal awards expended for the following noncash items (see paragraphs 5.13 through 5.15 for additional discussion):

- Loans and loan guarantees, including those at institutions of higher education

³ The implementation date for this provision is for audits of fiscal years beginning after June 30, 1998.

- Prior loans and loan guarantees
- Endowment funds
- Free rent
- Noncash assistance, such as free rent, food stamps, food commodities, donated property, or donated surplus property
- Medicare payments to a nonfederal entity for providing patient care services
- Medicaid payments to a subrecipient for providing patient care services

Subrecipient and Vendor Determinations

2.15 An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient are subject to audit under Circular A-133. The payments received for goods or services provided as a vendor would not be considered federal awards. Circular A-133 provides specific guidance on determining whether payments constitute a federal award or a payment for goods and services. This guidance is discussed further in chapter 9.

Major Program Determination

Risk-Based Approach

2.16 Circular A-133 requires the auditor to use a risk-based approach to determine which federal programs are major programs. The risk-based approach includes consideration of current and prior audit experience, oversight by federal agencies and pass-through entities, and the inherent risk of the federal programs. This risk-based approach and the determination of major programs are discussed in chapter 7.

Low-Risk Auditee

2.17 Circular A-133 contains certain criteria for considering an auditee to be a low-risk auditee. A low risk-auditee is eligible for reduced audit coverage. It should be noted that *low-risk auditee* is a term defined in Circular A-133 for the purpose of applying the percentage-of-coverage rule (see paragraphs 7.24 and 7.25) in the risk-based approach. It does not imply or require the auditor to assess audit risk or any of its components as low for an entity that meets the Circular A-133 definition of a low-risk auditee.

Cluster of Programs

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

Federal Agency Selection of Additional Major Programs

2.19 A federal agency may request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. After consultation with its auditor, the auditee should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach (described in chapter 7) and, if not, the estimated incremental cost. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon the federal agency request, and the federal agency agrees to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach may also be used by pass-through entities for a subrecipient.

Auditee Responsibilities

Preparation of Appropriate Financial Statements

2.20 Circular A-133 requires auditees to prepare financial statements that reflect their financial position, the results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements must be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits in accordance with Circular A-133 and prepare separate financial statements (see paragraph 3.25 for a further discussion). Circular A-133 also requires auditees to prepare a schedule of expenditures of federal awards for the period covered by the financial statements. (The schedule of expenditures of federal awards is discussed in chapter 5.)

Summary Schedule of Prior Audit Findings

2.21 The auditee is also required to prepare a summary schedule of prior audit findings. The schedule should report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards. It should also include audit findings reported in the prior audit's summary schedule of prior audit findings, except audit findings that have been corrected or are no longer valid. See paragraphs 10.68 through 10.70 for a further discussion of this schedule.

Other Responsibilities

2.22 In addition to the responsibilities described in paragraphs 2.20 and 2.21, Circular A-133 establishes certain other responsibilities for auditees, including the following:

- Identifying in its accounts all federal awards received and expended and the federal programs under which they were received, including, as applicable, the CFDA title and number, the award number and year, the name of the federal agency, and the name of the pass-through entity
- Establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the

auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs

- Complying with laws, regulations, and the provisions of contract or grants agreements related to each of its federal programs
- Ensuring that the audits required by Circular A-133 are properly performed and submitted when due
- Following up and taking corrective action on audit findings (including the preparation of a summary schedule of prior audit findings (see paragraph 2.21) and a corrective action plan (see paragraph 2.26); corrective action should be initiated within six months after the receipt of the audit report and proceed as rapidly as possible

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

2.23 Although not specifically stated in Circular A-133, the auditee is also responsible for complying with the requirements of laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on the financial statements and for establishing and maintaining effective internal control over financial reporting. These responsibilities support the requirements of *Government Auditing Standards*.

Reporting Package

2.24 The auditee is also required to submit a reporting package that includes financial statements and a schedule of expenditures of federal awards (see paragraph 2.20 and chapters 4 and 5), the summary schedule of prior audit findings (see paragraph 2.21), the auditor's reports (see paragraph 2.8), and a corrective action plan (see paragraph 2.26). Although not part of the reporting package, the submission of the report must also include the data collection form described in paragraph 2.25. The report submission requirements of Circular A-133 are described in paragraphs 2.9 and 10.74 through 10.79. Auditees must keep one copy of the data collection form and the reporting package on file for three years from the date of submission to the federal clearinghouse. Furthermore, unless restricted by law or regulation, the auditee is required to make copies of the data collection form and the reporting package available for public inspection.

Data Collection Form

2.25 The auditee is required to complete and sign certain sections of a data collection form which states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit. The auditor is also required to complete and sign certain sections of this form. See paragraphs 10.71 through 10.73 for a further discussion of the data collection form.

Corrective Action Plan

2.26 At the completion of the audit, the auditee should prepare a corrective action plan to address each audit finding included in the current year's auditor's reports. See paragraphs 10.68 through 10.70 for a further discussion of the corrective action plan.

Federal Awarding Agency Responsibilities

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

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

Pass-Through Entity Responsibilities

2.28 Pass-through entities have many responsibilities that are similar to those of federal awarding agencies. See chapter 9 for a detailed description of the responsibilities of pass-through entities.

Cognizant Agency for Audit

Definition

2.29 Circular A-133 defines the cognizant agency for audit as a federal agency designated to carry out the federal responsibilities with regard to a single audit. For recipients expending more than \$25 million a year in federal awards, the cognizant agency for audit will be the federal awarding agency that provides the predominant amount of direct funding to the recipient unless the OMB makes a specific cognizant agency for audit assignment. The determination of the predominant amount of direct funding is based on the direct federal awards expended by a recipient during its fiscal year ending in 1995, 2000, 2005, and every fifth year thereafter. For example, the audit cognizance for periods ending in 1997 through 2000 will be determined based on the federal awards expended in 1995.⁴ Audit cognizance can be reassigned if both the old and the new federal agencies notify the auditee (and, if known, the auditor), of the change within thirty days of the reassignment. A recipient may have one federal agency responsible for audit cognizance and another federal agency responsible for the negotiation of indirect costs.

Responsibilities

2.30 Circular A-133 states that a cognizant agency for audit is responsible for—

- Providing technical audit advice and liaison to auditees and auditors.

⁴ It should be noted that for states and local governments that expend more than \$25 million a year in federal awards and have previously assigned cognizant agencies for audit, the requirements in this paragraph are not effective until fiscal years beginning after June 30, 2000.

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

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

Oversight Agency for Audit

Definition

2.31 An auditee that does not have a designated cognizant agency for audit that (that is, one that expends \$25 million or less in federal awards) will have an oversight agency for audit. Circular A-133 defines the oversight agency for audit as a federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit (see paragraphs 2.29 and 2.30). When there is no direct funding, the federal agency with the predominant indirect funding is required to assume the oversight responsibilities.

Responsibilities

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

Program-Specific Audits

2.33 Circular A-133 provides general guidance on performing program-specific audits. In many cases, a program-specific audit guide will be available from the federal agency's Office of Inspector General. The audit guide will provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. When a program-specific audit guide is not available, the auditee and auditor have basically the same responsibilities for the federal program as they would have for an audit of a major program in a single audit. Program-specific audits are discussed further in chapter 11.

OMB Circular A-133 Compliance Supplement

2.34 The *Compliance Supplement* is based on the requirements of the Single Audit Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits. The *Compliance Supplement* serves to identify existing compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Single Audit Act and Circular A-133. For the programs included in the *Compliance Supplement*, it provides a source of information for auditors to understand the federal program's objectives, procedures, and compliance requirements relevant to the audit, as well as the audit objectives and suggested audit procedures for determining compliance with these requirements. It also provides guidance to assist auditors in determining compliance requirements relevant to the audit, audit objectives, and suggested audit procedures for programs not included in the *Compliance Supplement*. For single audits, the *Compliance Supplement* replaces agency audit guides and other audit requirement documents for individual federal programs.

2.35 The *Compliance Supplement* is effective for audits of fiscal years beginning after June 30, 1996, and supersedes the compliance supplements, *Audits of States and Local Governments* (issued in 1990), and *Audits of Institutions of Higher Education and Other Non-Profit Organizations* (issued in 1991). The *Compliance Supplement* is discussed in greater detail in paragraphs 1.27, 1.28, and 6.21 through 6.30.

Chapter 3

PLANNING AND OTHER SPECIAL AUDIT CONSIDERATIONS OF CIRCULAR A-133

3.1 In planning an audit to meet the requirements of Circular A-133, the auditor needs to consider several matters in addition to those ordinarily associated with an audit of financial statements in accordance with GAAS and *Government Auditing Standards*.¹ In this chapter the overall planning considerations in a single audit conducted in accordance with Circular A-133 are discussed. Many of these planning considerations are also applicable in a program-specific audit. Program-specific audits are discussed in detail in chapter 11.

3.2 The following matters are relevant to the planning of a single audit:

- Satisfying Circular A-133 requirements and other relevant legal, regulatory, or contractual requirements (see paragraphs 3.3 through 3.5)
- Establishing an understanding with the auditee (see paragraphs 3.6 and 3.7)
- Satisfying the additional requirements of *Government Auditing Standards* (see paragraphs 3.8 through 3.21)
- Satisfying the additional requirements of the Single Audit Act and Circular A-133 regarding working papers and audit follow-up (see paragraphs 3.22 through 3.24)
- Defining the entity to be audited (see paragraph 3.25)
- Determining the audit period (see paragraphs 3.26 and 3.27)
- Initial-year audit considerations (see paragraphs 3.28 and 3.29)
- The timing of the completion of the audit and reporting submission deadlines (see paragraph 3.30)
- Determining the major programs to be audited (see paragraph 3.31)
- The preliminary assessment of audit risk (see paragraph 3.32)
- Audit materiality considerations (see paragraphs 3.33 through 3.38)
- Determining compliance requirements (see paragraph 3.39)
- Developing an efficient audit approach (see paragraph 3.40)
- Joint audits and reliance on others (see paragraphs 3.41 through 3.44)
- Existence of internal audit function (see paragraph 3.45)
- Communications with the cognizant agency for audit and others (see paragraph 3.46)

¹ In AICPA *Professional Standards*, AU section 311, "Planning and Supervision," the auditor's responsibilities for planning and supervision in an audit of financial statements in accordance with GAAS are described. Paragraphs 4.6 and 4.7 of *Government Auditing Standards* describe its planning requirements.

- Understanding the applicable state and local compliance and reporting requirements (see paragraphs 3.47 through 3.49)
- Desk reviews and on-site reviews (see paragraphs 3.50 and 3.51)
- The restriction on the auditor's preparation of indirect cost proposals (see paragraph 3.52)
- The exit conference (see paragraphs 3.53 and 3.54)

Satisfying Circular A-133 Requirements and Other Relevant Legal, Regulatory, or Contractual Requirements

3.3 Because of the variety of audit requirements to which entities receiving federal awards are subject, paragraph 21 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801.21), states that auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. The auditor should consider including a statement about the type of engagement and whether it is intended to meet specific audit requirements in a proposal, in a contract, or in the communication issued to establish an understanding with the auditee (see paragraphs 3.6 and 3.7 for a further discussion of the establishment of an understanding with the auditee).

3.4 Management is also responsible for obtaining audits that satisfy relevant legal, regulatory, or contractual requirements. Paragraph 22 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.22) states that GAAS do not require the auditor to perform procedures beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. However, if during a GAAS audit of the financial statements, the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.² For example, the auditor will be required to make this communication if he or she is engaged to perform an audit of an entity's financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement, the entity is also required to have an audit performed in accordance with one or more of the following:

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

3.5 Paragraph 23 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.23) states that the required communication may be oral or written. If the communication is oral, the auditor should document the communication

² For 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.

in the working papers. The auditor should consider how the client's actions in response to such a communication relate to other aspects of the audit, including their potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54, *Illegal Acts by Clients*, and SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*.

Establishing an Understanding With the Auditee

3.6 SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310), states that the auditor should establish an understanding with the auditee regarding the services to be performed. Such understanding reduces the risk that either the auditor or the auditee may misinterpret the needs or expectations of the other party. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and the limitations of the engagement. The auditor should document this understanding in the working papers, preferably through a written communication with the auditee. If the auditor believes an understanding with the client has not been established, he or she should decline to accept the engagement.

3.7 SAS No. 83 includes a listing of the matters that should generally be included when the auditor establishes an understanding with the auditee regarding an audit of the financial statements. In addition to those matters, the auditor should also consider including the following information in the communication when he or she is engaged to perform a single audit:

- A description of the financial statements and supplemental schedule(s) to be audited
- The reporting period
- The auditing standards and requirements that will be followed (for example, GAAS, *Government Auditing Standards*, and Circular A-133)
- The objective of an audit in accordance with Circular A-133
- A description of the reports the auditor is expected to prepare and issue, including any limitation on their use
- A description of management's responsibility for (a) the financial statements and the schedule of expenditures of federal awards; (b) internal control over financial reporting and internal control over compliance; (c) compliance with laws, regulations, and the provisions of contracts and grant agreements; (d) following up and taking corrective action on audit findings, including the preparation of a summary schedule of prior audit findings and a corrective action plan; and (e) submitting the reporting package
- A statement that management has made the auditor aware of significant vendor relationships where the vendor is responsible for program compliance (so that the auditor can determine if additional procedures on vendor records will be necessary—see paragraphs 9.16 and 9.17)
- A description of the auditor's responsibility in an audit of financial statements and in a compliance audit of major programs under Circular A-133, including the determination of major programs, the consideration of internal control, and reporting responsibilities

- Other communications that may arise from the audit
- A description of the working paper retention requirements
- A statement that the working papers will be made available upon request to appropriate federal agencies and the GAO
- The communication with audit committees or other responsible individuals required by *Government Auditing Standards* (see paragraphs 3.19 and 3.20 for a further discussion of this requirement)

SAS No. 83 also states that the establishment of an understanding may be communicated in the form of an engagement letter.

Satisfying the Additional Requirements of *Government Auditing Standards*

3.8 Circular A-133 requires that audits of the financial statements and of the federal awards of the auditee be performed in accordance with *Government Auditing Standards* (see chapter 4 for a further discussion). In an audit in accordance with *Government Auditing Standards*, the auditor has considerations beyond those in a GAAS audit. *Government Auditing Standards* incorporates the fieldwork and reporting standards of GAAS and has general standards (described in chapter 2 of *Government Auditing Standards*) that are similar to those of the AICPA (that is, auditor qualifications, independence, and due professional care). However, *Government Auditing Standards* also contains additional general, fieldwork, and reporting requirements, which are summarized in Table 3.1 and discussed in detail in the three subsequent sections of this chapter.

Table 3.1

Additional Financial Statement Audit Requirements of *Government Auditing Standards*

General Requirements

- Continuing professional education (CPE) in subjects directly related to the government environment and to government auditing or to the specific or unique environment that the audited entity operates in
- Appropriate internal quality control system and external quality control review every three years

Fieldwork Requirements

- Audit follow-up requirements on known material findings and recommendations from previous audits
- Plan audit to provide reasonable assurance of detecting misstatements resulting from noncompliance with provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts
- Additional working paper requirements

Reporting Requirements

- Communication with audit committees or other responsible individuals
 - Referring to *Government Auditing Standards* in the auditor's report
 - Reporting on compliance with laws and regulations and on internal controls
 - Consideration of privileged and confidential information
 - Report distribution
-

3.9 *Government Auditing Standards* also provides additional guidance on audit materiality, on fraud³ and illegal acts, and on internal controls. Table 3.2 summarizes where this additional guidance is provided in *Government Auditing Standards* and also where it is discussed in this SOP.

Table 3.2

| Additional Guidance in Government Auditing Standards | | |
|---|--|--------------------------------|
| <i>Area of Additional Guidance</i> | <i>Government Auditing Standards Reference</i> | <i>SOP Reference</i> |
| Materiality | Paragraphs 4.8 and 4.9 | Paragraph 3.34 |
| Fraud and illegal acts | Paragraphs 4.14 through 4.17 | Paragraphs 10.21 through 10.25 |
| Internal controls | Paragraphs 4.21 through 4.33 | Paragraphs 4.17 and 4.18 |

General Requirements

Continuing Professional Education

3.10 Government Auditing Standards requires auditors to participate in a program of continuing professional education (CPE) and training. Every two years, all auditors (whether certified or not) performing audits in accordance with *Government Auditing Standards* should complete at least eighty credit hours of training that contribute directly to their professional proficiency. At least twenty of those hours should be completed in each year of the two-year period. For auditors responsible for planning, directing, or reporting on the audit and for auditors conducting substantial portions of the audit, at least twenty-four hours should be in subjects directly related to the government environment and to government auditing. If the auditee operates in a specific or unique environment, auditors should receive training that is related to that environment. For example, if the auditor performs an audit of a not-for-profit organization, the twenty-four hours should be in topics related to the not-for-profit accounting and auditing environment. These could include compliance and government-related courses or those broadly related to the type of not-for-profit organization being audited.

3.11 *Interpretation of Continuing Education and Training Requirements*, a detailed interpretation of the foregoing CPE standards, is available from the GPO (stock number 020-000-00250-6). Among other things, this interpretation discusses who is subject to the CPE requirements and what programs, activities, and subjects qualify as acceptable CPE. During engagement planning, auditors and audit organizations should ensure that members of the audit team have met or will meet the appropriate CPE requirements within two years of the start of the first audit in accordance with *Government Auditing Standards*, and every two years thereafter.

Quality Control

3.12 *Government Auditing Standards* also states that the audit organization should have in place an appropriate internal quality control system and

³ The term *fraud* as used in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, is synonymous with the term *irregularities* as used in *Government Auditing Standards*. Therefore, in discussing the requirements of *Government Auditing Standards*, this SOP will use the term *fraud* instead of the term *irregularities*.

undergo an external quality control review (for example, a peer review). An external quality control review should be conducted at least once every three years by an organization not affiliated with the organization being reviewed.

3.13 *Government Auditing Standards* further requires audit organizations seeking to enter into a contract to perform an audit in accordance with *Government Auditing Standards* to provide their most recent external quality control review report to the party contracting for the audit. Auditors are not required to provide separate letters of comment. Auditors should consider documenting in the working papers the provision of the quality control review report to the party contracting for the audit.

Fieldwork Requirements

Audit Follow-Up

3.14 *Government Auditing Standards* states that the auditee is responsible for resolving audit findings and recommendations. It further requires auditors to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. The purpose of this follow-up is to determine whether the auditee has taken timely and appropriate corrective actions. *Government Auditing Standards* also requires auditors to report the status of uncorrected material findings and recommendations that are from prior audits and that affect the financial statement audit. (See paragraphs 3.24, 6.61 through 6.67, and 10.62 for a further discussion of the auditor's responsibility for audit follow-up under both *Government Auditing Standards* and Circular A-133 and how these responsibilities correlate.)

Responsibilities With Regard to the Provisions of Contracts and Grant Agreements

3.15 Paragraph 4.13 of *Government Auditing Standards* refers to additional responsibilities with regard to detecting material misstatements resulting from noncompliance with the provisions of contract and grant agreements that have a direct and material effect on the determination of financial statement amounts. However, it has generally been interpreted under GAAS that the phrase *laws and regulations* in SAS No. 54 implicitly includes the provisions of contracts and grant agreements. Thus, the auditor's responsibility with regard to detecting material misstatements resulting from noncompliance with the provisions of contracts and grant agreements under *Government Auditing Standards* equates to the auditor's responsibility under GAAS.

Working Papers

3.16 SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), provides guidance on the auditor's preparation and maintenance of working papers. *Government Auditing Standards* includes an additional standard that requires working papers to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments. This additional standard requires working papers to include sufficient documentation of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records. *Government Auditing Standards* also states that auditors should provide for working paper access to other auditors, to facilitate reviews of audit

quality and reliance by other auditors on the auditor's work, and should provide for such access in contractual arrangements for *Government Auditing Standards* audits (see paragraphs 3.22 and 3.23 for a discussion of the working paper access and retention requirements under Circular A-133).

3.17 Audits done in accordance with *Government Auditing Standards* are subject to review by other auditors and by oversight officials more frequently than are audits done in accordance with GAAS. Thus, whereas GAAS cites two main purposes of working papers (providing the principal support for the audit report and aiding auditors in the conduct and supervision of the audit), working papers serve an additional purpose in audits performed in accordance with *Government Auditing Standards*. Working papers allow for the review of audit quality by providing the reviewer written documentation of the evidence supporting the auditor's significant conclusions and judgments.

3.18 *Government Auditing Standards* specifically states that working papers should contain—

- The objectives, scope, and methodology, including any sampling criteria used.
- Documentation of the work performed to support significant conclusions and judgments, including descriptions of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records.⁴
- Evidence of supervisory reviews of the work performed.

Reporting Requirements

Communication With Audit Committees or Other Responsible Individuals

3.19 *Government Auditing Standards* includes an additional reporting standard that requires the auditor to communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit. This standard applies in all situations in which there is an audit committee or the audit is performed under contract. In other situations, the auditor may still find it useful to communicate with management or other officials of the auditee, although it is not required. The auditor should communicate the following information to the audit committee or representatives of the contractor:

- a. The auditor's responsibilities in a financial statement audit, including his or her responsibilities for testing and reporting on internal control and compliance with laws and regulations
- b. The nature of any additional testing of internal controls and compliance required by laws and regulations
- c. The responsibilities and the nature of any additional testing described in items *a* and *b* should be contrasted with other financial related audits of internal control and compliance (to help responsible parties understand the limitations of the auditor's responsibilities for testing and reporting on internal control and compliance)

⁴ Auditors may meet this requirement by listing voucher numbers, check numbers, or other means of identifying specific documents they examined. Auditors are not required to include in the working papers copies of documents they examined nor are they required to list detailed information from those documents.

3.20 Professional judgment should be used in determining the form and content of the communication, which may be oral or written. If the communication is oral, the auditor should document the communication in the working papers. If written, the required communication may be issued as a separate communication or as part of the auditor's communication issued to establish an understanding with the auditee (see paragraphs 3.6 and 3.7).

Other Additional Reporting Requirements

3.21 The other additional reporting requirements of *Government Auditing Standards*—referring to *Government Auditing Standards* in the auditor's report, reporting on compliance with laws and regulations and on internal control, consideration of privileged and confidential information, and report distribution—are addressed in paragraphs 10.15 and 10.16.

Satisfying the Additional Requirements of the Single Audit Act and Circular A-133 Regarding Working Papers and Audit Follow-Up

Working Papers

3.22 The Single Audit Act states that upon request by a federal agency or the Comptroller General, any independent auditor conducting a single audit should make the auditor's working papers available to the federal agency or the Comptroller General (a) as part of a quality review, (b) to resolve audit findings, or (c) to carry out oversight responsibilities. It also states that access to the auditor's working papers shall include the right to obtain copies. The Single Audit Act intends that federal agencies be judicious in the exercise of this authority and that the release of the working papers should not compromise the confidentiality of proprietary information. The Single Audit Act also intends that any trade secrets and confidential commercial or financial information obtained from the working papers be treated as confidential under the Freedom of Information Act. Auditors should refer to the guidance in the AICPA Auditing Interpretation titled *Providing Access to or Photocopies of Working Papers to a Regulator* (AICPA, *Professional Standards*, vol. 1, AU sec. 9339), when a regulator requests access to the auditor's working papers pursuant to law, regulation, or audit contract.

3.23 Circular A-133 requires that auditors retain working papers and reports for a minimum of three years after the date of issuance of the auditor's report to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. When the auditor is aware that the federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor is required to contact the parties contesting the audit finding for guidance prior to the destruction of the working papers and reports.

Audit Follow-Up

3.24 In addition to the requirements of *Government Auditing Standards*, Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year au-

dit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. (See paragraphs 6.61 through 6.67 and 10.62 for a further discussion of the responsibility for audit follow-up under both Circular A-133 and *Government Auditing Standards* and how these responsibilities correlate.)

Defining the Entity to Be Audited

3.25 One of the initial tasks during the planning process of a single audit is determining whether management has properly defined the entity to be audited. Circular A-133 requires that single audits must cover the entire operations of the auditee. However, Circular A-133 provides auditees the option to meet the audit requirements of the circular through a series of audits that cover an auditee's departments, agencies, and other organizational units which expended or otherwise administered federal awards during a fiscal year. If an auditee elects this option, then separate financial statements and a schedule of expenditures of federal awards must be prepared for each such department, agency, or other organizational unit. In these circumstances, an auditee's organization-wide financial statements may also include departments, agencies, or other organizational units that have separate audits and prepare separate financial statements. For example, if a local government has its school districts audited separately, it would be acceptable for the local government's financial statements to include the school districts, even though the school districts were not included in the local government's Circular A-133 audit, because a separate Circular A-133 audit was conducted of the school districts. However, if separate financial statements were not prepared for the school districts, it would be unacceptable for a separate Circular A-133 audit to be conducted of the school districts (that is, the local government's organization-wide financial statements could not be used as a substitute for separate financial statements for the school districts). See paragraph 10.34 for a discussion of the situation where the implementation regulations of certain federal agencies define the entity to be audited differently than GAAP.

Determining the Audit Period

Fiscal Year and Program Period May Differ

3.26 An audit performed in accordance with Circular A-133 should cover the auditee's financial transactions (including transactions related to federal awards) for its fiscal year (or a two-year period, if allowed by Circular A-133), which is not necessarily the same as the period of the program being funded (see paragraph 2.5 for further information on biennial audits). Thus, the audit might include only a part of the transactions of a federal award, because some transactions may not occur within the period covered by the audit.

Stub Periods

3.27 Stub periods may occur when an auditee converts from a program-specific audit to a single audit or changes audit periods. One example would be a community college with a September 30 year end that previously had a program-specific audit and is now converting to a single audit. The prior program-specific audits were performed based on a June 30 award year. The first single audit will be for the year ending September 30. This would leave the community college with an unaudited stub period of June 30 to September

30. Arrangements should be made to meet the audit requirements for federal expenditures during the stub period. This is usually done either as a separate audit of the stub period or by including expenditures of the stub period with the following period's Circular A-133 audit. The cognizant or oversight agency for audit or the pass-through entity should be contacted for advice on how stub periods should be addressed.

Initial-Year Audit Considerations

Preceding Period Audited by Another Auditor

3.28 Whenever an auditor is considering accepting an engagement in which the federal awards of the preceding period were audited by another auditor, he or she should refer to the guidance in SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315). It provides guidance on communications between predecessor and successor auditors when a change in auditors is in process or has taken place, and it includes illustrative letters. SAS No. 84 also provides communications guidance when possible misstatements are discovered in financial statements reported on by a predecessor auditor.

Factors to Consider Under the Risk-Based Approach

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

- Federal awards expended by federal program
- Prior-period findings and questioned costs (including the corrective action plan and management decision related to the findings and summary schedule of prior audit findings)
- Whether the predecessor auditor used the exception that allows deviation from the risk-based approach during the last three years (see paragraph 7.20)
- Correspondence from program officials indicating potential problems
- New programs
- Changes to programs
- Amount of funding passed through to subrecipients by individual federal program
- Extent to which computer processing is used to administer federal programs
- Federal programs audited as major programs for the last two years

Timing of the Completion of the Audit and Reporting Submission Deadlines

3.30 When planning the timing of the audit, auditors should be aware that Circular A-133 requires that the audit be completed and the data collection form and reporting package (described in paragraphs 2.24, 2.25, 10.6, 10.7,

and 10.71 through 10.73) be submitted to the federal clearinghouse within a certain time period. The timing requirements are discussed in detail in paragraphs 10.74 through 10.79.

Determining the Major Programs to Be Audited

3.31 As discussed in paragraphs 2.16 through 2.19, Circular A-133 requires the auditor to use a risk-based approach to determine which federal programs are major programs. This determination will affect the scope of the audit and the compliance requirements to be tested. The determination of major programs is discussed further in chapter 7.

Preliminary Assessment of Audit Risk

3.32 As required by SAS No. 54, 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. While not explicitly stated in SAS No. 54, it has generally been interpreted that the phrase “laws and regulations” implicitly includes provisions of contracts and grant agreements. (Auditors should note that *Government Auditing Standards* explicitly states that the auditor should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with the provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statements amounts.) Circular A-133 further requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. In developing an audit plan, the auditor should assess the risk that noncompliance may cause the financial statements to contain a material misstatement or may have a material effect on each major program. Furthermore, the auditor should consider risk factors related to the risk of noncompliance with those laws, regulations, and provisions of contracts and grant agreements and to the related control activities designed to prevent or to detect such noncompliance. As required by SAS No. 82, the auditor should also specifically assess the risk of material misstatement of the financial statements because of error or fraud and should consider that assessment in designing the audit procedures to be performed (see paragraphs 4.32 through 4.37). Audit risk is discussed in greater detail in paragraphs 6.7 through 6.12.

Audit Materiality Considerations

3.33 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance on the auditor’s consideration of materiality when he or she plans and performs an audit of financial statements in accordance with GAAS. Materiality, as it relates to the financial statement audit, is further discussed in the following related AICPA Audit and Accounting Guides:

- *Not-for-Profit Organizations*
- *Audits of State and Local Governmental Units*
- *Health Care Organizations*
- *Audits of Colleges and Universities*⁵

⁵ Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

Materiality Guidance in Government Auditing Standards

3.34 As noted in paragraph 3.9, *Government Auditing Standards* contains guidance on certain areas, including materiality considerations. Paragraphs 4.8 and 4.9 of *Government Auditing Standards* state that “auditors’ consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.”

Materiality Differences Between the Financial Statement Audit and the Single Audit

3.35 In auditing compliance with requirements governing major programs in accordance with Circular A-133, the auditor’s consideration of materiality differs from that in an audit of financial statements in accordance with GAAS and *Government Auditing Standards*. In an audit of financial statements, materiality is considered in relation to the financial statements being audited. In designing audit tests and developing an opinion on an auditee’s compliance with requirements having a direct and material effect on each major program, however, the auditor considers materiality in relation to each major program (see paragraphs 6.13 through 6.16 for a further discussion of materiality considerations).

Materiality for Purposes of Reporting Audit Findings

3.36 Circular A-133 requires the auditor to consider a lower level of materiality for purposes of reporting audit findings in the schedule of findings and questioned costs. The auditor should be cautious that this “audit finding” materiality not be confused with (a) the materiality used for planning and performing the single audit, (b) giving an opinion on the financial statements, and (c) giving an opinion on the auditee’s compliance with requirements having a direct and material effect on each major program (see paragraph 3.35 above).

3.37 Among other findings that must be reported, Circular A-133 requires the auditor to report material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program in the schedule of findings and questioned costs (other findings that are required to be reported are described in paragraph 10.63). The auditor’s determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement (for example, activities allowed or unallowed, cash management, eligibility, or reporting) for a major program or an audit objective identified in the *Compliance Supplement*.

3.38 For example, when the auditor discovers one or more instances of noncompliance involving the reporting type of compliance requirement for a particular major program, several materiality determinations must be made using professional judgment. First, the auditor must decide whether the noncompliance is material to the reporting type of compliance requirement for the

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

Determining Compliance Requirements

3.39 In planning the consideration of the internal control and compliance aspects of the audit, the auditor should obtain from management the principal compliance requirements at the start of the audit (see paragraph 4.27 for a listing of possible audit procedures to assess management's identification of compliance requirements). The auditee and auditor may also ascertain the principal compliance requirements for the largest federal programs by referring to the *Compliance Supplement*. For programs not included in the *Compliance Supplement*, auditors should refer to part 7 of that document, which provides guidance for auditing programs not included in the *Compliance Supplement*. Among other things, part 7 instructs auditors to review the federal award document and referenced laws and regulations applicable to the program, the CFDA, and previously issued compliance supplements (see paragraph 6.30 for further information).

Developing an Efficient Audit Approach

3.40 Auditors should consider planning and performing a single audit to achieve maximum audit efficiency. Examples of ways to achieve audit efficiency follow.

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

Joint Audits and Reliance on Others

3.41 Circular A-133 encourages auditees, whenever possible, to make positive efforts to utilize small business, minority-owned firms, and women's business enterprises. In keeping with the spirit of this provision, certain audi-

tees may engage such independent accounting firms on a joint-venture or subcontract basis. In these instances it may be necessary to refer to the work of other auditors. Prior to entering into an agreement to perform a joint audit or to subcontract with another firm, the auditor should consider SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*, and Ethics Interpretation 101-10, *The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements*.

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

3.43 If part of the single audit is performed by governmental auditors, the auditors should be satisfied that the government auditors meet the independence standards in chapter 3 of *Government Auditing Standards* as well as the CPE and quality control standards. These standards require that government auditors be free from organizational, personal, and external impairments to independence and that they maintain an independent attitude and appearance.

3.44 Another common occurrence, particularly in a governmental environment, is the separation of a single audit between the principal auditor of the reporting entity and a secondary auditor of a component unit included in the financial statements of the reporting entity (see paragraph 3.25). The principal auditor's report on the financial statements of the reporting entity most often refers to the report of the secondary auditor as it relates to the financial statements of the component unit. The principal auditor may also need to refer to the programs audited by other auditors in his or her reports on the schedule of expenditures of federal awards, compliance, and internal control related to federal awards, as they relate to federal awards administered by the component unit. In such cases, the auditor should follow the guidance in SAS No. 1, section 543.

Existence of Internal Audit Function

3.45 Another factor the auditor should consider when planning the single audit is whether the auditee has an internal audit function and the extent to which internal auditors are involved in monitoring compliance with specified requirements. The auditor should consider the guidance in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), when addressing the competence and objectivity of internal auditors; the nature, timing, and extent of work to be performed; and other related matters (for example, in obtaining an understanding of the entity's internal control over financial reporting and compliance, assessing audit risk, and performing substantive procedures).

Communications With the Cognizant Agency for Audit and Others

3.46 When professional judgment indicates it is appropriate, the auditor may communicate with the cognizant agency for audit, the oversight agency for audit, federal awarding agencies, pass-through entities, state auditors, or state

awarding agencies, to aid in planning the audit. The auditor might want to consider documenting such communications, as well as any decisions rendered as a result. If a planning meeting is held, matters such as the following may be discussed:

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

Understanding the Applicable State and Local Compliance and Reporting Requirements

Impact on Circular A-133 Audit

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

Compliance Audits of State or Local Grants

3.48 When engaged to audit one or more grants subject to state or local compliance requirements, the auditor should consider performing the following procedures:

- Determine whether the state or local government has a compliance supplement or other audit guide for the program.
- Inquire of management about the additional compliance auditing requirements applicable to the entity.
- Inquire of the audit divisions of the sponsoring agencies about the audit requirements applicable to the entity.

- Obtain any applicable audit guidance from the grantor agency (including any audit guides, amendments, administrative rulings, and the like) pertaining to the grant.
- Read the grant agreements and any amendments, including referenced laws and regulations.
- Review information about governmental audit requirements that is available from state societies of CPAs or associations of governments.
- When appropriate, discuss with the grantor agency the scope of the testing that is expected to be performed.

Compliance Audits Not Involving Governmental Assistance

3.49 Guidance for engagements related to management's written assertion about an entity's compliance with specified state or local laws, regulations, rules, or contracts not involving governmental financial assistance is provided in Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500).

Desk Reviews and On-Site Reviews

3.50 In addition to the quality control requirements set forth in *Government Auditing Standards* (see paragraphs 3.12 and 3.13), cognizant agencies for audit have implemented procedures for evaluating the quality of audits. These procedures include both desk reviews and on-site reviews (note that the oversight agencies for audit may also perform these reviews). As a part of the cognizant agencies' evaluation of the completed reports of such engagements, and, as required by Circular A-133, the supporting audit working papers must be made available upon request of the representative of the federal agency. Audit working papers are typically reviewed at a location agreed upon by the cognizant agency for audit and the independent auditor. (See the additional discussion in paragraphs 3.16 and 3.22 regarding working paper access issues.)

3.51 Whenever a review of the audit report or the working papers discloses an inadequacy, the audit firm is contacted for corrective action. Where major inadequacies are identified and the representative of the cognizant agency for audit determines that the audit report and the working papers are substandard, cognizant agencies may take further steps. In those instances in which the audit was determined to be substandard by the federal agency, the matter may be submitted to state boards of public accountancy.

Restriction on the Auditor's Preparation of Indirect Cost Proposals

3.52 Circular A-133 precludes the auditor who prepares the indirect cost proposal or cost allocation plan from performing the single audit when indirect costs recovered during the prior year by the auditee exceed \$1 million. This restriction applies to the base year used in the preparation of the indirect proposal or cost allocation plan and to any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. The implementation date for this provision is for audits of fiscal years beginning after June 30, 1998. For example, an auditor who prepares an indirect cost

proposal or cost allocation plan that is used as the basis for charging indirect costs in the fiscal year ending June 30, 1999, is not permitted to perform the 1999 single audit (assuming that the indirect costs recovered during the prior year exceeded \$1 million).

Exit Conference

3.53 Upon completion of fieldwork, the auditor should consider holding a closing or exit conference with senior officials of the auditee. The exit conference gives the auditor an opportunity to obtain management's comments on the accuracy and completeness of his or her facts and conclusions, including whether or not management concurs with the audit findings. This conference also serves to provide the auditee with advance information so that it may initiate corrective action without waiting for a final audit report. In the case of decentralized operations, as at a university, auditors should consider having preliminary meetings with deans, department heads, and other operating personnel who have direct responsibility for financial management systems and the administration of sponsored projects.

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

Chapter 4

FINANCIAL STATEMENT AUDIT CONSIDERATIONS UNDER CIRCULAR A-133

Introduction

4.1 Circular A-133 requires auditees to prepare financial statements that reflect their financial position, their results of operations or changes in net assets, and, where appropriate, their cash flows for the fiscal year. The financial statements must be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits and prepare separate financial statements (see paragraph 4.5 below). Circular A-133 also requires auditees to prepare a schedule of expenditures of federal awards for the period covered by the financial statements. (The schedule of expenditures of federal awards is discussed in chapter 5.)

4.2 Circular A-133 does not prescribe the basis of accounting that must be used by auditees to prepare their financial statements. However, auditees are required to disclose the basis of accounting and significant accounting policies used in preparing the financial statements. Auditees must be able to reconcile amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards.

4.3 Circular A-133 does, however, require the auditor to report whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP). This results in the expression of an opinion or a disclaimer of opinion. (Guidance on reporting on the financial statements of the auditee appears in chapter 10.) If the auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP,¹ the auditor is still required to express or disclaim an opinion and should follow the reporting guidance in SAS No. 62, *Special Reports*.

4.4 The financial statements are also required to be audited in accordance with *Government Auditing Standards* (see paragraphs 3.8 through 3.21, 4.17 through 4.19, and 4.41). Circular A-133 does not impose on the financial statement audit any additional audit requirements beyond *Government Auditing Standards*.

4.5 The audit must cover the entire operations of the auditee, or at the option of the auditee, the audit may include a series of audits that cover departments, agencies, and other organizational units that expended or otherwise administered federal awards during the fiscal year, provided that each audit encompasses the financial statements and schedule of expenditures of federal awards for each such department, agency, and other organizational unit (see paragraph 3.25 for a further discussion).

¹ A comprehensive basis of accounting other than GAAP is defined in paragraph 4 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04).

4.6 In performing the financial statement audit, the auditor should refer to the accounting and auditing guidance applicable to specific industries as found in the following AICPA Audit and Accounting Guides: *Not-for-Profit Organizations*, *Audits of State and Local Governmental Units*, *Health Care Organizations*, and *Audits of Colleges and Universities*.²

4.7 In this chapter, the requirements of GAAS related to the auditor's consideration of compliance and internal control over financial reporting in a financial statement audit are summarized and the additional requirements of *Government Auditing Standards* in those areas are discussed.

Consideration of Internal Control Over Financial Reporting

4.8 In the following paragraphs the requirements of GAAS and *Government Auditing Standards* applicable to the auditor's consideration of internal control over financial reporting in a financial statement audit are described.

Summary of GAAS Requirements

4.9 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent auditor's consideration of an auditee's internal control in an audit of financial statements in accordance with GAAS, defines internal control, describes the objectives and components of internal control, and explains how an auditor should consider internal control in planning and performing an audit.

4.10 When obtaining an understanding of internal control over financial reporting and assessing control risk for the assertions embodied in the financial statements, the auditor should refer to SAS No. 55, as amended by SAS No. 78, and to guidance applicable to specific industries as found in the AICPA Audit and Accounting Guides listed in paragraph 4.6.

Definition of Internal Control

4.11 The definition of internal control in both SAS No. 55, as amended by SAS No. 78, and Circular A-133 is consistent with the definition and description of internal control contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. The definition is as follows:

Internal control means a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

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

² Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

Control Objectives

4.12 The three categories of control objectives described previously are what an auditee strives to achieve. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs of the auditee and others regarding each separate purpose. In general, controls that are relevant to an audit of financial statements pertain to the auditee's objective of the reliability of financial reporting and involve the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP or a comprehensive basis of accounting other than GAAP (see footnote 1 of this chapter). However, controls pertaining to the operations and compliance objectives may also be relevant to a financial statement audit to the extent that they pertain to data the auditor evaluates or uses in applying auditing procedures to the financial statements. Controls relevant to an audit of the financial statements are referred to collectively in this SOP as "internal control over financial reporting" and are encompassed in the reporting on internal control required by *Government Auditing Standards* (see paragraphs 10.38 through 10.40). Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this SOP as "internal control over compliance" and are encompassed in the report on internal control required by Circular A-133 (see paragraphs 10.46 through 10.49). In a particular single audit engagement, some controls may be relevant to both the audit of the financial statements and the audit of compliance. When this occurs, those controls would be encompassed in both internal control reports. Section 505 of Circular A-133 provides guidance on reporting findings involving reportable conditions in internal control in such a circumstance (see paragraph 10.56).

Components of Internal Control

4.13 The five components of internal control are the control environment, risk assessment, control activities, information and communication, and monitoring. SAS No. 55, as amended by SAS No. 78, requires the auditor to obtain an understanding of each of those components that is sufficient to plan the audit by performing procedures to understand (a) the design of controls relevant to an audit of financial statements, and (b) whether they have been placed in operation. In all audits of financial statements, including those audited as part of a single audit, this understanding incorporates knowledge about the design of controls relevant to compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts, as well as knowledge about whether they have been placed in operation. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

Relationship Between Objectives and Components

4.14 There is a direct relationship between the three categories of control objectives (what an auditee strives to achieve) and the control components (what is needed to achieve the objectives). Although an auditee's internal control addresses objectives in each of the categories referred to in the definition of internal control in paragraph 4.11, not all of these objectives and related controls are relevant to an audit of the auditee's financial statements.

Documentation Requirements

4.15 SAS No. 55, as amended by SAS No. 78, requires the auditor to document the understanding of the auditee's internal control components that

was obtained to plan the audit. In addition, the auditor should document the basis for his or her conclusions about the assessed level of control risk. The form and extent of this documentation is influenced by the size and complexity of the auditee, as well as by the nature of the auditee's internal control (see paragraphs 3.16 through 3.18 for a discussion of the working paper requirements of *Government Auditing Standards*). Auditors should refer to SAS No. 55, as amended by SAS No. 78, for more detail on the documentation requirements related to internal control over financial reporting.

Communication Requirements

4.16 The auditor should consult the guidance in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), for guidance on identifying and reporting conditions that relate to an entity's internal control over financial reporting observed during an audit of financial statements (see also paragraphs 4.19 and 10.26 through 10.30). The auditor should also consult the guidance in SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), for required communications to persons who have responsibility for the oversight of the financial reporting process (see also paragraph 10.14).

Responsibilities Under Government Auditing Standards

Fieldwork

4.17 *Government Auditing Standards* does not prescribe any additional fieldwork standards with respect to the auditor's consideration of internal control over financial reporting beyond those required in an audit conducted in accordance with GAAS. However, paragraphs 4.22 through 4.33 of *Government Auditing Standards* provide guidance on four aspects of internal control over financial reporting that are important to the judgments auditors make about audit risk and about the evidence needed to support their opinion on the financial statements. These aspects are summarized as follows:

- **Control environment.** Auditors' judgments about the control environment may influence (either positively or negatively) judgments about specific control procedures.
- **Safeguarding controls.** These are the controls that prevent or timely detect unauthorized transactions and unauthorized access to assets resulting in possible losses that are material to the financial statements. Therefore, the understanding of safeguarding controls assists auditors in planning the audit to detect material misappropriations as well as to assess other risks that the financial statements could be materially misstated.
- **Controls over compliance with laws and regulations.** These are important to auditors in identifying the types of potential misstatements that could occur and the factors that could affect the risk of material misstatement. Such information can help 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.
- **Control risk assessments.** These are important in determining the nature, timing, and extent of the audit tests to be performed. *Government Auditing Standards* reminds auditors that when control risk is

assessed below the maximum for a given financial statement assertion, the need for evidence from substantive tests of that assertion is reduced. Auditors are not required to assess control risk below the maximum and to rely on controls. However, auditors may find it efficient to do so for larger entities or those with complex operations. The auditors' ability to rely on controls is directly related to the evidence obtained to show that the controls work. Auditors may find it necessary to reconsider assessments of control risk when substantive tests detect misstatements.

4.18 The auditor should consider this guidance as it relates to the consideration of the auditee's internal control over financial reporting in the audit of the financial statements.

Reporting

4.19 Reporting on the internal control over financial reporting under *Government Auditing Standards* differs from such reporting under SAS No. 60. *Government Auditing Standards* requires written reporting on internal control over financial reporting in all audits. SAS No. 60 requires communication (either written or oral) only when the auditor has noted reportable conditions. *Government Auditing Standards* requires a description of any reportable conditions noted, including the identification of those that are individually or cumulatively material weaknesses. SAS No. 60 permits, but does not require, the auditor to identify and communicate separately, as material weaknesses, those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses. Finally, *Government Auditing Standards* requires communication of the following matters, which are not addressed by SAS No. 60: (a) a description of the scope of the auditor's testing of internal control and the results of those tests and (b) deficiencies in internal control that are not considered reportable conditions (see the discussion in paragraph 10.29). See paragraphs 3.19 through 3.20 and 10.26 through 10.30 for a more detailed discussion of the reporting requirements related to internal control over financial reporting.

Compliance Considerations

4.20 The auditor should be aware of the unique characteristics of the compliance auditing environment. States, local governments, and not-for-profit organizations differ from commercial enterprises in that they may be subject to diverse compliance requirements. Management is responsible for ensuring compliance with relevant laws and regulations. That responsibility encompasses the identification of applicable laws and regulations and the establishment of internal control designed to provide reasonable assurance that the auditee complies with those laws and regulations.

4.21 In the following paragraphs, the requirements of GAAS that are applicable to the auditor's consideration of compliance in a financial statement audit are summarized and the additional requirements of *Government Auditing Standards* are discussed.

Summary of GAAS Requirements

General Guidance

4.22 SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, pro-

vides general guidance when the auditor is engaged to audit an entity that receives federal awards, including audits performed under GAAS, *Government Auditing Standards*, and Circular A-133. SAS No. 74 describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit and also discusses the auditor's responsibility for compliance auditing related to federal awards in an audit performed under Circular A-133. The auditor's responsibility for compliance auditing related to federal awards is discussed in chapter 6 of this SOP.

4.23 The auditor is required to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations, error, or fraud. SAS No. 54, *Illegal Acts by Clients*, describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82, describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors. The requirements of SAS Nos. 54, 82, and 47 are described in paragraphs 4.24 through 4.38.

SAS No. 54 Requirements

4.24 SAS No. 54 requires the auditor to 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. This involves identifying laws and regulations that may have a direct and material effect on the determination of financial statement amounts, and then assessing the risk that noncompliance with these laws and regulations may cause the financial statements to contain a material misstatement. The auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se.

4.25 Although it has not been explicitly stated in SAS No. 54, the phrase "laws and regulations" has generally been interpreted to implicitly include the provisions of contract and grant agreements (see paragraph 3.15). Laws, regulations, and provisions of contracts and grant agreements are referred to in this SOP as "compliance requirements." Violations of laws, regulations, and provisions of contracts and grant agreements are referred to in this SOP as "instances of noncompliance."

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

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

4.27 The auditor may consider performing the following procedures in assessing management's identification of these compliance requirements and

in obtaining an understanding of their possible effects on the determination of financial statement amounts:

- a. Consider knowledge about these compliance requirements that has been obtained from prior years' audits.
- b. Discuss these compliance requirements with the auditee's chief financial officer, legal counsel, or grant administrators.
- c. Obtain written representation from management regarding the completeness of management's identification of compliance requirements (see paragraph 4.40).
- d. Review the relevant portions of any directly related agreements, such as those related to grants and loans.
- e. Identify sources of revenue, review any related agreements (for example, loan agreements or grant agreements) and inquire about the applicability of any overall governmental regulations to the accounting for the revenue.
- f. Obtain publications pertaining to compliance requirements. These publications often address federal tax and other reporting requirements, such as the Department of the Treasury and the Internal Revenue Service requirements pertaining to information returns and regulations concerning the calculation of arbitrage rebates and refunds.
- g. Obtain copies of, and review pertinent sections of, the state constitution, laws, and regulations concerning the auditee. The sections of these documents pertaining to financial reporting, debt, taxation, budget, and appropriation and procurement matters may be especially relevant.
- h. Review the minutes of meetings of the governing body of the auditee for the enactment of laws and regulations or information about contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- i. Inquire of the office of the federal, state, or local auditor or other appropriate audit oversight organization about the compliance requirements applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.
- j. Review information about applicable federal and state program compliance requirements, such as the information included in the *Compliance Supplement*, the CFDA, and state and local policies and procedures.
- k. Review the guidance contained in the applicable AICPA Audit and Accounting Guides referred to in paragraph 4.6 and review the materials available from other professional organizations, such as state societies of CPAs or industry associations.
- l. Inquire of the audit, finance, or program administrators from which grants are received about the restrictions, limitations, terms, and conditions under which such grants were provided. These administrators can usually be helpful in identifying compliance requirements, which they may identify separately or publish in an audit guide.

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

- The materiality of the effect on financial statement amounts.
- The level of management or employee involvement in the compliance-assurance process.
- The opportunity for concealment of instances of noncompliance.

4.29 As part of assessing the risk of material misstatement, the auditor should assess the risk that instances of noncompliance may cause such a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting instances of noncompliance that are material to the financial statements. Therefore, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from instances of noncompliance that have a direct and material effect on the determination of financial statement amounts (see paragraph 6.53 for a discussion of the impact on the financial statements of actual and projected errors noted in a single audit, and see paragraph 10.42 for a discussion of situations that could occur when the auditor reports on the results of compliance testing).

4.30 Auditees may be affected by many other laws and regulations, including those related to occupational safety and health, environmental protection, equal employment, food and drug, and price fixing. These laws and regulations generally concern an auditee's operations more than financial reporting and accounting. Their effect on an auditee's financial statements is indirect and normally takes the form of the disclosure of a contingent liability that follows from the allegation or determination of illegality. The auditor would not ordinarily have sufficient basis to recognize possible violations of these laws and regulations. Even when violations of such laws and regulations can have consequences that are material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he or she is informed by the auditee, or unless there is evidence of an investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.³

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

SAS No. 82 Requirements

4.32 SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110), states

³ In 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 (a) the client's policies relative to the prevention of illegal acts and (b) the use of directives issued by the client, as well as periodic representations obtained by the client, from management at appropriate levels of authority, concerning compliance with laws and regulations.

that the auditor also has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. SAS No. 82 provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.

4.33 Although fraud is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of financial statements is intentional or unintentional. Two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets. These two types of misstatements, as well as the characteristics of fraud, are discussed further in paragraphs 3 through 10 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.03 through 316.10).

4.34 The risk of material misstatement of the financial statements due to fraud is part of audit risk. Therefore, the auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets in each of the following categories:

Misstatements Arising From Fraudulent Financial Reporting

- Management's characteristics and influence over the control environment
- Industry conditions
- Operating characteristics and financial stability

Misstatements Arising From the Misappropriation of Assets

- Susceptibility of assets to misappropriation
- Controls

The auditor should exercise professional judgment when considering (a) risk factors individually or in combination and (b) whether there are specific controls that mitigate the risk. Risk factors are discussed in greater detail in paragraphs 16 through 25 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU secs. 316.16 through 316.25).

4.35 As noted previously, an auditor's interest specifically relates to fraudulent acts that cause a material misstatement in the financial statements. When the auditor is identifying risk factors and other conditions in an audit of financial statements performed in conjunction with a single audit, the auditor's responsibilities under SAS No. 82 are expanded to include (in addition to the risk factors normally associated with financial statements) the consideration of risk factors associated with the receipt of federal awards that could present a material misstatement of the financial statements. Auditors may wish to refer to the AICPA practice aid titled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which includes specific nonauthoritative guidance on applying the concepts of SAS No.

82 to several industries, including government, health care, and not-for-profit organizations. Among other things, it identifies example risk factors for those industries, including risk factors that relate to recipients of federal awards.

4.36 In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud. Where risk factors are identified as being present, the documentation should include (a) those risk factors identified and (b) the auditor's response to those risk factors, individually or in combination. In addition, if, during the performance of the audit, fraud risk factors or other conditions are identified that cause the auditor to believe that an additional response is required, these risk factors or other conditions, as well as any further response that the auditor concluded was appropriate, should also be documented.

4.37 SAS No. 82 also contains requirements on the auditor's response to the results of the assessment of risk, the evaluation of audit test results, and communications about fraud to management, the audit committee, and others. Auditors should refer to SAS No. 82 for a description of the specific requirements in those areas (see also paragraphs 10.18 through 10.20).

SAS No. 47 Requirements

4.38 SAS No. 47, as amended by SAS No. 82, provides guidance to auditors in fulfilling the responsibility described in paragraph 4.32, as it relates to errors, in an audit of financial statements conducted in accordance with GAAS. Errors are described as unintentional misstatements, or as omissions of amounts or disclosures, in financial statements. Errors may involve (a) mistakes in gathering or processing data from which financial statements are prepared, (b) unreasonable accounting estimates arising from oversight or the misinterpretation of facts, and (c) mistakes in the application of accounting principles relating to amounts, classification, the manner of presentation, or disclosure. When the auditor is considering his or her responsibility to obtain reasonable assurance that the financial statements are free of material misstatement, there is no important distinction between error and fraud. There is a distinction, however, in the auditor's response to detected misstatements. An isolated, immaterial error in processing accounting data or in applying accounting principles is generally not significant to the audit. In contrast, when fraud is detected, the auditor should consider its implications for the integrity of management or employees and its possible effect on other aspects of the audit. Auditors should refer to SAS No. 47 for more detailed guidance.

Working Paper Documentation

4.39 The auditor should document the 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*. (See paragraphs 3.16 through 3.18 of this SOP for a discussion of the *Government Auditing Standards* requirements related to working papers.) The fraud risk factors identified and the auditor's response to those risk factors should be documented in accordance with SAS No. 82 (see paragraph 4.36). The auditor's understanding of internal control over financial reporting 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, as amended by SAS No. 78 (see paragraph 4.15).

Written Representations From Management

4.40 SAS No. 85, *Management Representations*, requires the auditor to obtain written representations from management as part of an audit conducted in accordance with GAAS. It also includes an illustrative management representation letter and an appendix containing additional representations that may be appropriate to be included in a management representation letter in certain circumstances. With respect to compliance requirements affecting the financial statement audit, auditors should consider obtaining additional representations from management acknowledging that management (see paragraphs 6.68 and 6.69 for a discussion of additional management representations in a single audit)—

- a. Is responsible for compliance with the laws, regulations, and provisions of contracts and grant agreements applicable to the auditee.
- b. Is responsible for establishing and maintaining effective internal control over financial reporting.
- c. Has identified and disclosed to the auditor all laws, regulations, and provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- d. Has identified and disclosed to the auditor violations (or possible violations) of laws, regulations, and provisions of contracts and grant agreements whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

Additional Responsibilities Under Government Auditing Standards

4.41 *Government Auditing Standards* prescribes as part of the financial statement audit additional fieldwork and reporting requirements beyond those in GAAS that are related to compliance. The additional fieldwork responsibilities are related to audit follow-up on known material findings and recommendations from previous audits, as well as to working paper access and documentation. (See paragraphs 3.14 through 3.18 of this SOP for a further discussion of these requirements.) With regard to reporting, *Government Auditing Standards* requires, among other things, that the auditor report on the scope of his or her testing of compliance and present the results of those tests. See paragraphs 10.15 and 10.16 for a more detailed discussion of the *Government Auditing Standards* reporting requirements related to compliance.

Reasonable Assurance

4.42 SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), states that since the auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her audit report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with GAAS.

Chapter 5

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Overview of Schedule Requirements

5.1 Circular A-133 requires the auditor to determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole. This schedule, prepared by the auditee, reports the total expenditures for each federal program (see paragraph 1.18 for the Circular A-133 definition of federal programs). In this chapter the identification of federal awards, the general presentation requirements governing the schedule, pass-through awards, non-cash awards, and endowment funds are described. The auditor's reporting on the schedule is discussed in paragraphs 10.36 and 10.37.

Identification of Federal Awards

Federal Agency and Pass-Through Entity Requirements

5.2 Circular A-133 requires federal agencies and pass-through entities to identify the federal awards made by informing each recipient or subrecipient of the CFDA title and number, the award's name and number, the award year, and whether the award is for R&D. When some of this information is not available, the federal agency or pass-through entity is required to provide the information necessary to describe the federal award clearly.

Auditee Requirements

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

Auditor Assessment of Auditee Identification of Federal Programs

5.4 In assessing the appropriateness and completeness of the auditee's identification of federal programs in the schedule, the auditor should consider, among other matters, evidence obtained from audit procedures performed to evaluate the completeness and classification of recorded revenues and expenditures. This may include sending confirmations to granting federal agencies or pass-through entities in an audit of a subrecipient. When the auditee is unable to identify federally funded expenditures separately, the auditor should consider whether a reportable condition exists. If it does, a finding should be reported in the schedule of findings and questioned costs (see chapter 10 for a further discussion of reporting findings and the schedule of findings and questioned costs).

General Presentation Requirements

Basis of Accounting

5.5 Circular A-133 does not prescribe the basis of accounting that must be used by the auditee to prepare the schedule of expenditures of federal awards. Some auditees may choose to prepare the schedule on a basis of accounting that is different from that in the financial statements. In any case, the auditee is required to disclose the basis of accounting and the significant accounting policies used in preparing the schedule. The auditee must also be able to reconcile amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards.

Required Schedule Contents

5.6 Circular A-133 requires the auditee to prepare a schedule of expenditures of federal awards for the period covered by the auditee's financial statements. At a minimum, the schedule should—

- List individual federal programs by federal agency. For federal programs included in a cluster of programs (see paragraphs 1.18, 1.19, and 2.18), list individual federal programs within a cluster of programs. For R&D, the total federal awards expended must be shown either by individual award or by federal agency and major subdivision within the federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services (the federal agency).
- Include, for federal awards received as a subrecipient, the name of the pass-through entity and the identifying number assigned by the pass-through entity.
- Provide the total federal awards expended for each individual federal program and the CFDA number or other identifying number when the CFDA information is not available.
- Include notes that describe the significant accounting policies used in preparing the schedule.
- Identify, to the extent practical, the total amount provided to subrecipients by pass-through entities from each federal program (see chapter 9 for a further discussion of the audit considerations of federal pass-through awards).
- Include, in either the schedule or a note to the schedule, the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end (see paragraph 5.13).

Example schedules of expenditures of federal awards appear in appendix C.

Providing Additional Information

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

Schedule Not in Agreement With Other Federal Award Reporting

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

Inclusion of Nonfederal Awards

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

CFDA Number Not Available

5.10 The auditee may be unable to obtain the CFDA number, which is sometimes the case for new federal programs and R&D programs. In addition, cost-type contracts will normally not have a CFDA number. When the CFDA number is not available, the auditee should indicate that fact and should include in the schedule the program's name and, if available, other identifying number.

Pass-Through Awards

Treatment of Pass-Through Awards

5.11 Circular A-133 defines a subrecipient as an entity that expends federal awards that are received from a pass-through entity to carry out a federal program. State or local government redistributions of federal awards to subrecipients, known as "pass-through awards," should be treated by the subrecipient as though they were received directly from the federal government. Accordingly, pass-through awards should be included in the scope of the single audit on the same basis as that of federal awards that are received directly. The audit considerations of federal pass-through awards are discussed further in chapter 9. As noted in paragraph 5.6, in addition to the other general presentation requirements, Circular A-133 requires the schedule to include the name of the pass-through entity and the identifying number assigned by the pass-through entity for federal awards received as a subrecipient.

Commingled Assistance

5.12 The individual sources (that is, federal, state, and local) of federal awards may not be separately identifiable because of commingled assistance from different levels of government. If the commingled portion cannot be separated to specifically identify the individual funding sources, the total amount should be included in the schedule, with a footnote describing the commingled nature of the funds.

Noncash Awards

Treatment of Noncash Awards

5.13 Most federal awards are in the form of cash awards. However, there are a number of federal programs that do not involve cash transactions. These programs may include food stamps, commodities, loan guarantees, loans, surplus property, interest rate subsidies, or insurance. Circular A-133 requires the value of federal awards expended in the form of noncash assistance (such as loan guarantees, loans, insurance programs, surplus property, food stamps issued, or commodities distributed) to be reported either on the face of the schedule or disclosed in the notes to the schedule. The OMB states in Circular A-133 that although it is not required, it is preferable to present this information in the schedule rather than in the notes to the schedule. See paragraphs 2.13 and 2.14 for a discussion on determining when awards, including noncash awards, are considered to be expended.

Determining the Value of the Noncash Awards Expended

5.14 Table 5.1 shows the bases generally used to determine the value of noncash awards expended (see section 205 of Circular A-133 for additional details).

Loan and Loan Guarantee Continuing Compliance Requirements

5.15 As noted previously, in determining the value of total noncash awards expended for loans and loan guarantees, the balances of loans from previous years must be included if the federal government imposes continuing compliance requirements. Circular A-133 does not specifically define the term *continuing compliance requirements*. Therefore, it is a matter of judgment as to whether continuing compliance requirements are significant enough to require inclusion of prior-year loan or loan guarantee balances. For example, if in a prior year an auditee expended the proceeds of a federal loan to construct a building, and the current-year activity consists only of loan repayments and a requirement by the federal lender for the auditee to submit a report that only details loan payment information, it may not be necessary to include the prior year's loan balance in determining the total amount of loans expended. However, if the federal lender requires the auditee to ensure on an ongoing basis that a certain percentage of the building is rented to low-income residents, it would likely be necessary to include the prior year's loan balance in determining the total amount of loans expended. The auditor should consider contacting the federal agency Office of Inspector General for assistance in determining whether continuing compliance requirements are significant enough to require inclusion of the balances of prior loans or loan guarantees.

Table 5.1**Determining the Value of Noncash Awards Expended**

| <i>Types of Noncash Awards</i> | <i>Basis Used to Determine the Value of Noncash Awards Expended</i> |
|---|---|
| Loans and loan guarantees | Value of new loans made or received during the fiscal year plus the balance of loans from previous years for which the federal government imposes continuing compliance requirements (see paragraph 5.15), plus any interest subsidy, cash, or administrative cost allowance received. |
| Loans and loan guarantees (loans) at institutions of higher education | When loans are made to students but the institution of higher education does not make the loans, only the value of loans made during the year are considered federal awards expended. The balance of loans for previous years is not included because the lender accounts for the prior balances. |
| Insurance | Fair market value of insurance contract at the time of receipt, or the assessed value provided by the federal agency. |
| Food stamps | Fair market value of food stamps at the time of receipt, or the assessed value provided by the federal agency. |
| Commodities | Fair market value of commodities at the time of receipt, or the assessed value provided by the federal agency. |
| Donated property or donated surplus property | Fair market value of donated property or donated surplus property at the time of receipt, or the assessed value provided by the federal agency. |
| Free rent | Fair market value of free rent at the time of receipt, or the assessed value provided by the federal agency. Free rent is not considered an award expended unless it is received as part of an award to carry out a federal program. |

* The proceeds of loans that were received and expended in prior years are not considered federal awards expended when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

Endowment Funds

5.16 Circular A-133 states that the cumulative balance of federal awards for endowment funds which are federally restricted are considered awards expended in each year in which the funds are still restricted.

Chapter 6

COMPLIANCE AUDITING APPLICABLE TO MAJOR PROGRAMS

6.1 In this chapter the auditor's consideration of compliance requirements applicable to major programs in a single audit under Circular A-133 is discussed (as noted in paragraph 11.5, much of the guidance in this chapter would also be applicable to a program-specific audit when a program-specific audit guide is not available). The consideration of internal control over compliance for major programs is discussed in chapter 8. The related reporting requirements are discussed in chapter 10. The auditor's consideration of the auditee's compliance with laws, regulations, and the provisions of contracts or grant agreements in a financial statement audit is discussed in chapter 4.

Single Audit Compliance Objectives

6.2 In addition to a financial statement audit in accordance with GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs (these are hereinafter referred to as "compliance requirements"). A single audit results in the auditor expressing an opinion on the auditee's compliance with these compliance requirements for each of its major programs. To express such an opinion, the auditor accumulates sufficient evidence by planning and performing tests of transactions and such other auditing procedures as are necessary in support of the entity's compliance with applicable compliance requirements, thereby limiting audit risk to an appropriately low level.

Responsibilities of Auditee

6.3 The auditee is responsible (a) for complying with the compliance requirements related to each of its federal programs and (b) for establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. The auditor should obtain management's written representations regarding its compliance and internal control responsibilities as discussed in paragraphs 6.68 and 6.69.

6.4 The form and extent of the documentation of management's compliance will vary depending on the nature of the compliance requirements and the size and complexity of the entity. The auditee may have documentation in the form of accounting or statistical data, case files, entity policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, or internal auditors' reports.

Use of Professional Judgment

6.5 The planning, conduct, and evaluation of the results of compliance testing in a single audit require the auditor to exercise professional judgment. The following factors may be considered by the auditor in applying his or her professional judgment:

- The assessment of inherent risk, control risk, and fraud risk
- The assessment of materiality
- The evidence obtained from other auditing procedures
- The amount of expenditures for the program
- The diversity or homogeneity of expenditures for the program
- The length of time that the program has operated, or changes in its conditions
- The current and prior auditing experience with the program, particularly findings in previous audits and other evaluations (that is, inspections, program reviews, or system reviews required by the federal acquisition regulations)
- The extent to which the program is carried out through subrecipients, as well as the related monitoring activities
- The extent to which the program contracts for goods or services
- The level to which the program is already subject to program reviews or other forms of independent oversight
- The expectation of noncompliance or compliance with the applicable compliance requirements
- The extent to which computer processing is used to administer the program, as well as the complexity of the processing
- Whether the program has been identified as being high-risk by the OMB in the *Compliance Supplement*

Audit Risk Considerations

6.6 To express an opinion on compliance, the auditor accumulates sufficient evidence in support of compliance, thereby limiting audit risk to an appropriately low level. The auditor's consideration of audit risk and materiality when he or she plans and performs a single audit is similar to the consideration in a financial statement audit in accordance with SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

Components of Audit Risk

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

- *Inherent risk*—the risk that material noncompliance with a major program's compliance requirements could occur, assuming there is no related internal control

- *Control risk*—the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the entity's internal control
- *Fraud risk*—the risk that intentional material noncompliance with a major program's compliance requirements could occur
- *Detection risk*—the risk that the auditor's procedures will lead him or her to conclude that noncompliance that could be material to a major program does not exist when, in fact, such noncompliance does exist

In paragraphs 6.8 through 6.12, each of these components of audit risk is discussed and an explanation of how the components of audit risk interrelate in providing a basis for the auditor's opinion on compliance is given.

Inherent Risk

6.8 In assessing inherent risk, the auditor should consider factors that are relevant to compliance engagements. Such factors include the following (the factors listed in paragraph 6.5 should also be considered):

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

6.9 The auditor's assessment of inherent risk over major programs may be performed in part when the auditor is determining major programs using the risk-based approach (see paragraph 7.36). The nature of some programs may indicate higher inherent risk. Programs with higher inherent risk may be of a higher risk for the purpose of determining major programs. Circular A-133 provides the following examples for program characteristics with potentially higher inherent risks:

- Complex programs and the extent to which a program contracts for goods and services have the potential for higher risk. For example, federal programs that disburse funds through third-party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high risk for time-and-effort reporting but may otherwise be at low risk.
- The phase of a federal program's life cycle at the federal agency may indicate risk. For example, a new program with new or interim regulations may have a higher risk than an established program with time-tested regulations. In addition, significant changes in federal programs, laws, or regulations or in the provisions of contracts or grant agreements may increase risk.
- The phase of a program's life cycle at the auditee may indicate risk. For example, during the first and last years in which an auditee participates in a program, the risk may be higher because of the start-up or closeout of the program's activities and staff.
- Type B programs with larger federal awards expended would be of higher risk than would programs with substantially smaller federal awards expended.

Control Risk

6.10 Circular A-133 requires the auditor to plan the testing of internal control over compliance for major programs, to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. The circular does not, however, actually require the achievement of a low assessed level of control risk. The assessment of control risk contributes to the auditor's evaluation of the risk that material noncompliance exists in a major program. The process of assessing control risk (together with assessing inherent risk and fraud risk) provides evidential matter about the risk that such noncompliance may exist. The auditor uses this evidential matter as part of the reasonable basis for his or her opinion on compliance. The auditor's consideration of internal control over compliance for major programs, including the assessment of control risk, is discussed in chapter 8.

Fraud Risk

6.11 SAS No. 82 provides guidance to the auditor on his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud (see paragraphs 4.32 through 4.37). Because SAS No. 82 only applies to an audit of financial statements, its requirements do not apply to an audit of an auditee's compliance with specified requirements applicable to its major programs. However, as part of assessing audit risk in a single or program-specific audit, the auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. The auditor should consider that assessment in designing the audit procedures to be performed. Auditors may wish to refer to the AICPA practice aid titled, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which identifies example risk factors that relate to recipients of federal awards. When the auditor has assessed fraud risk and has deemed that a further response is necessary, the guidance in paragraphs 26 through 32 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.26–.32) may be helpful.

Detection Risk

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

Materiality Considerations

6.13 In a compliance audit, the auditor's consideration of materiality differs from that in an audit of financial statements (see paragraphs 3.33 through

3.38). Materiality is affected by (a) the nature of the compliance requirements, which may or may not be quantifiable in monetary terms, (b) the nature and frequency of noncompliance identified with an appropriate consideration of sampling risk, and (c) qualitative considerations, such as the needs and expectations of federal agencies and pass-through entities. Qualitative factors that indicate that an identified instance of noncompliance may be immaterial include (a) a low risk of public or political sensitivity, (b) a single exception that has a low risk of being pervasive, or (c) an indication, based on the auditor's judgment and experience, that the affected federal agency or pass-through entity would normally not need to resolve the finding or take follow-up action.

Materiality Judgments About Compliance Applied to Each Major Program Taken as a Whole

6.14 In designing audit tests and developing an opinion on the auditee's compliance with compliance requirements, the auditor should apply the concept of materiality to each major program taken as a whole, rather than to all major programs combined.

6.15 For purposes of evaluating the results of compliance testing, a material instance of noncompliance is defined as a failure to follow requirements, or a violation of prohibitions, established by law, regulation, contract, or grant that results in an aggregation of noncompliance (that is, the auditor's best estimate of the overall noncompliance) that is material to the affected federal program. It should be noted that several instances of noncompliance that may not be individually material should be assessed to determine if, in the aggregate, they could have a material effect. Because the auditor expresses an opinion on each major program and not on all the major programs combined, reaching a conclusion about whether the instances of noncompliance (either individually or in the aggregate) are material to a major program requires consideration of the type and nature of the noncompliance, as well as the actual and projected effect on each major program in which the noncompliance was noted. Instances of noncompliance that are material to one major program may not be material to a major program of a different size or nature. In addition, the level of materiality relative to a particular major program can change from one audit to the next.

Effect of Material Noncompliance on the Financial Statements

6.16 If the tests of compliance reveal material noncompliance at the major program level, the auditor should consider its effect on the financial statements. The auditor should also consider the cumulative effect of all instances of noncompliance on the financial statements. (See also paragraphs 6.53 and 10.42.)

Performing a Compliance Audit

6.17 The auditor should exercise (a) due care in planning and performing the audit and in evaluating the results of his or her audit procedures, and (b) the proper degree of professional skepticism to achieve reasonable assurance that material noncompliance will be detected.

6.18 In performing compliance tests, the auditor should—

- a. Identify the auditee's major programs to be tested and reported on for compliance (paragraph 6.19 and chapter 7).
- b. Identify the applicable compliance requirements (paragraphs 6.20 through 6.30).
- c. Plan the engagement (paragraphs 6.31 through 6.34 and chapter 3).
- d. Consider relevant portions of the entity's internal control over compliance for major programs (paragraph 6.35 and chapter 8).
- e. Obtain sufficient evidence, which involves testing compliance with applicable compliance requirements (paragraphs 6.36 through 6.47).
- f. Consider subsequent events (paragraphs 6.48 through 6.50).
- g. Form an opinion about whether the auditee complied with the applicable compliance requirements (paragraphs 6.51 through 6.60).
- h. Perform follow-up procedures on previously identified findings (paragraph 6.61 through 6.67).

Identifying Major Programs to Be Tested

6.19 Circular A-133 requires the auditor to determine the major programs to be tested in a single audit using a risk-based approach. The application of the risk-based approach to determine major programs is discussed in chapter 7.

Identifying Applicable Compliance Requirements

6.20 The auditor must determine the applicable compliance requirements to be tested and reported on in a single audit (that is, those laws, regulations, and provisions of contracts or grant agreements that may have a direct and material effect on each major federal program). The auditor should use professional judgment in making this determination.

Compliance Supplement

6.21 The *Compliance Supplement* is based on the requirements of the Single Audit Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits (see paragraphs 1.27 through 1.29, 2.34, and 2.35 for additional discussion of the *Compliance Supplement* and for instructions on how to obtain a copy). The *Compliance Supplement* identifies the fourteen types of compliance requirements applicable to most federal programs. It also includes the compliance requirements specific to certain of the largest federal programs. Part 7 of the *Compliance Supplement* provides guidance to assist the auditor in identifying the compliance requirements for federal programs not included in the *Compliance Supplement* (see also paragraph 6.30).

Fourteen Types of Compliance Requirements

6.22 Part 3 of the *Compliance Supplement* lists and describes the fourteen types of compliance requirements and the related audit objectives that the auditor should consider in every audit conducted under Circular A-133, with the exception of program-specific audits performed in accordance with a federal agency's program specific audit guide (see paragraph 11.4). Suggested audit procedures are also provided to assist the auditor in planning and performing tests of the auditee's compliance with the requirements of federal programs. The auditor's judgment will be necessary to determine whether the suggested audit procedures are sufficient to achieve the stated audit objectives

and whether additional or alternative audit procedures are needed (see paragraph 6.44). The fourteen types of compliance requirements are as follows:

- A—activities allowed or unallowed
- B—allowable costs/cost principles
- C—cash management
- D—Davis-Bacon Act
- E—eligibility
- F—equipment and real property management
- G—matching, level of effort, earmarking
- H—period of availability of federal funds
- I—procurement and suspension and debarment
- J—program income
- K—real property acquisition and relocation assistance
- L—reporting
- M—subrecipient monitoring
- N—special tests and provisions

The auditor should consider the applicability of these compliance requirements to the auditee's major programs. Part 2 of the *Compliance Supplement* provides a matrix that is useful to the auditor for this purpose by identifying whether particular compliance requirements apply to the federal programs included in the *Compliance Supplement*. In making a determination not to test a compliance requirement identified as applicable to a particular program, the auditor must conclude either that the requirement does not apply to the particular auditee or that noncompliance with the requirements could not have a material effect on a major program.

Keeping Abreast of Changes in Compliance Requirements

6.23 Circular A-133 states that an audit of the compliance requirements related to federal programs contained in the *Compliance Supplement* will meet the requirements of the circular. However, it also states that when there have been changes to the compliance requirements and the changes are not reflected in the *Compliance Supplement*, the auditor must determine the current compliance requirements and modify the audit procedures accordingly.

6.24 Although Circular A-133 provides that federal agencies are responsible to inform the OMB annually of any updates needed to the *Compliance Supplement*, the auditor should recognize that laws and regulations change periodically and that delays will occur between such changes and revisions to the *Compliance Supplement*. Accordingly, the auditor should perform reasonable procedures to ensure that compliance requirements are current. Besides describing the compliance requirements, the *Compliance Supplement* includes references to the Code of Federal Regulations and other sources of information about the requirements. The auditor may refer to those other sources of information to identify significant changes to the requirements or perform other procedures, including the following:

- Discussions with appropriate individuals within the auditee organization (that is, the chief financial officer, internal auditors, legal counsel, the compliance officer, or grant or contract administrators)
- A review of contracts or grant agreements, new guidance material issued by the granting agency or pass-through entity (for example, handbooks and operating procedures), and correspondence from the granting agency or pass-through entity

- An inquiry of granting agency personnel (appendix III of the *Compliance Supplement* includes a listing of federal agency contacts, including addresses, phone numbers, and E-mail or Web page addresses that could be useful if the auditor decides to make such an inquiry)

Considering Additional Provisions of Contracts or Grant Agreements

6.25 The *Compliance Supplement* states that in addition to the compliance requirements identified in the supplement, auditors need to consider whether there are any provisions of contracts or grant agreements that are unique to a particular entity (for example, the grant agreement may specify the matching percentage, or an entity may have agreed to additional requirements that are not required by law or regulation, perhaps as part of a resolution of prior audit findings).

6.26 Therefore, in using the *Compliance Supplement* to identify applicable compliance requirements, the auditor needs to consider—

- a. The applicability to the federal program of the fourteen types of compliance requirements identified in part 3 of the *Compliance Supplement*.
- b. Additional compliance requirements specific to the federal program as identified in part 4 of the *Compliance Supplement*.
- c. Any provisions of contracts or grants that are unique to the particular entity.

Compliance Requirements Specific to Certain Federal Programs

6.27 Part 4 of the *Compliance Supplement* discusses program objectives, program procedures, and compliance requirements that are specific to each federal program included. With the exception of special tests and provisions, the auditor should refer to part 3 of the *Compliance Supplement* for the audit objectives and suggested audit procedures that pertain to the compliance requirements associated with each program. Since special tests and provisions are unique to each program, the audit objectives and suggested audit procedures for each program are included in part 4.

Compliance Requirements Specific to a Cluster of Programs

6.28 As noted in paragraph 2.18, a cluster of programs is a grouping of closely related programs that have similar compliance requirements (for example, SFA, R&D, and other clusters). Part 5 of the *Compliance Supplement* identifies those programs that are considered to be clusters of programs. It also provides compliance requirements, audit objectives, and suggested audit procedures for the clusters.

Relationship of the Compliance Supplement to Federal Program Audit Guides

6.29 The *Compliance Supplement* states that for single audits, the supplement replaces federal agency audit guides and other audit requirement documents for individual federal programs.¹ Accordingly, for a federal program

¹ Auditors should note that two federal agencies, the Department of Housing and Urban Development and the Department of Education have issued interim supplements to address the requirements of certain agency programs. Those supplements provide guidance similar to that provided in part 4 of the *Compliance Supplement*. A description of the supplements and the authoritative status of each are discussed in part 1 of the *Compliance Supplement*. Auditors should refer to the *Compliance Supplement* to determine whether to use the interim supplements or the *Compliance Supplement* for the federal programs included in the supplements. As of the date of this SOP, the OMB has indicated that the federal programs included in the Department of Education interim supplement will be included in the next revision of the *Compliance Supplement*.

included in the *Compliance Supplement* and having a separate federal program audit guide or other federal program audit requirement documents, the auditor needs to consider only those compliance requirements in the *Compliance Supplement* when performing a single audit (versus a program-specific audit).

Federal Programs Not Included in the Compliance Supplement

6.30 The *Compliance Supplement* does not include all federal programs from which an auditee may receive federal awards. Circular A-133 states that for those federal programs not covered in the *Compliance Supplement*, the auditor should use the fourteen types of compliance requirements (see paragraph 6.22) contained in the supplement as guidance for identifying the types of compliance requirements to test, and should determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements. The auditor should follow the guidance in part 7 of the *Compliance Supplement* for identifying the applicable compliance requirements to test and report on in a single audit. That guidance outlines the following steps to determine which compliance requirements to test:

- a. Identify the applicable compliance requirements for the federal program.
- b. Determine which of the compliance requirements identified in step a could have a direct and material effect on the major program.
- c. Determine which of the compliance requirements identified in step b are susceptible to testing by the auditor.
- d. Determine which of the fourteen types of compliance requirements would the compliance requirements identified in step c fall into.
- e. For special tests and provisions, determine the applicable audit objectives and audit procedures.

Part 7 of the *Compliance Supplement* provides more detailed guidance on the steps to perform to identify applicable compliance requirements.

Planning the Engagement

General Considerations

6.31 Planning a compliance audit involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, auditors need to have sufficient knowledge to enable them to understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on compliance. Proper planning and supervision contribute to the effectiveness of audit procedures. Proper planning directly influences the selection of appropriate procedures and the timeliness of their application, and proper supervision helps ensure that planned procedures are appropriately applied.

6.32 Factors to be considered by the auditor in planning a compliance audit include (a) the anticipated level of audit risk related to the compliance requirements on which the auditor will report (see paragraphs 6.6 through 6.12), (b) preliminary judgments about materiality levels for audit purposes (see paragraphs 6.13 through 6.16), and (c) conditions that may require extension or modification of audit procedures.

6.33 The nature, timing, and extent of planning will vary with the nature and complexity of the compliance requirements and the auditor's prior experience with the auditee. As part of the planning process, the auditor should consider the nature, timing, and extent of the work to be performed to accomplish the objectives of the compliance audit. Nevertheless, as the compliance audit progresses, changed conditions may make it necessary to modify planned procedures. For discussion of additional planning considerations, see chapter 3.

Multiple Components

6.34 In a compliance audit in which the auditee has operations in several components (for example, locations or branches), the auditor may determine that it is not necessary to test compliance with requirements at every component. In making such a determination and in selecting the components to be tested, the auditor should consider such factors as the following: (a) the degree to which the specified compliance requirements apply at the component level, (b) judgments about materiality, (c) the degree of centralization of the records, (d) the effectiveness of controls, particularly those that affect management's direct control over the exercise of authority delegated to others, as well as its ability to supervise activities at various locations effectively, (e) the nature and extent of operations conducted at the various components, and (f) the similarity of operations and controls over compliance for different components. See paragraph 8.13 for a discussion of internal control considerations for multiple components.

Consideration of Internal Control Over Compliance for Major Programs

6.35 The auditor should obtain an understanding of relevant portions of internal control over compliance sufficient to plan the audit and to assess control risk for compliance with specified requirements. In planning the audit, the auditor should use this knowledge to identify types of potential noncompliance, to consider factors that affect the risk of material noncompliance, and to design appropriate tests of compliance. Circular A-133 specifically requires the auditor to perform procedures to obtain an understanding of internal control over compliance for federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. Circular A-133 also requires the auditor to perform testing of controls as planned. In some instances, the auditor may be able to perform compliance testing for major programs concurrently with tests of controls (see paragraph 3.40). Any reportable conditions in internal control over compliance for major programs that are noted are required to be reported as an audit finding (see paragraph 10.63). Control risk is discussed further in paragraph 6.10, and the auditor's consideration of internal control over compliance for major programs (including the final control risk assessment and the performance of tests of controls) is discussed in more detail in chapter 8.

Performing Compliance Testing

6.36 Circular A-133 requires that compliance testing include tests of transactions and such other auditing procedures as are necessary to provide the auditor with sufficient evidence to support an opinion on compliance for each major program. Such compliance testing may be performed (a) concurrently with tests of controls, (b) as substantive testing, or (c) as a combination

of the two. In performing compliance testing, the auditor attempts to obtain reasonable assurance that the auditee complied, in all material respects, with the compliance requirements. This includes designing the compliance audit to detect both intentional and unintentional noncompliance. Absolute assurance is not attainable because of factors such as the need for judgment, the use of sampling, and the inherent limitations of internal control over compliance and because much of the evidence available to the auditor is persuasive rather than conclusive in nature. Furthermore, procedures that are effective for detecting unintentional noncompliance may be ineffective for detecting noncompliance that is intentional and is concealed through a collusion between the client's personnel and third parties or among the management or employees of the client. Therefore, the subsequent discovery that material noncompliance exists does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor.

6.37 In determining the nature, timing, and extent of tests to perform, the auditor's professional judgment regarding the appropriate level of detection risk should be used. In applying his or her judgment, the auditor should be aware that small sample sizes for tests of details with a low dollar value and from a large population generally do not, by themselves, provide sufficient evidence. In determining the nature, timing, and extent of the testing of an auditee's compliance with compliance requirements, the auditor should consider audit risk and materiality related to each major program. The auditor plans compliance tests to reduce detection risk to an acceptable level. The evidence provided by these tests, along with evidence regarding inherent risk and control risk, provides the basis for expressing an opinion on whether the auditee complied, in all material respects, with the compliance requirements for each major program.

6.38 In determining the nature of his or her tests of compliance with requirements governing major 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 expended the funds.

Sufficient Evidence

6.39 The auditor should apply procedures to provide reasonable assurance of detecting material noncompliance. The selection and application of procedures that will accumulate evidence that is sufficient in the circumstances to provide a reasonable basis for expressing an opinion on compliance require the careful exercise of professional judgment. A broad array of available procedures may be applied in a compliance audit. In establishing a proper combination of procedures to restrict audit risk appropriately, the auditor should consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to important exceptions:

- a. Evidence obtained from independent sources outside an entity provides greater assurance of an entity's compliance than evidence secured solely from within the entity.
- b. Information obtained from the auditor's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.

- c. The more effective the internal control, the greater the assurance it provides about the entity's compliance.

6.40 Thus, in the hierarchy of available audit procedures, those that involve search and verification (for example, inspection, confirmation, or observation)—particularly when independent sources outside the entity are used—are generally more effective in reducing audit risk than are those involving internal inquiries and comparisons of internal information (for example, analytical procedures and discussions with the individuals responsible for compliance).

6.41 In a compliance audit, the auditor's objective is to accumulate sufficient evidence to limit audit risk to a level that is, in the auditor's professional judgment, appropriately low for the high level of assurance being provided. An auditor should select from all available procedures (that is, procedures that assess inherent, control, and fraud risk and restrict detection risk)—any combination that can limit audit risk to such an appropriately low level.

6.42 For regulatory requirements, the auditor's procedures may include reviewing reports of significant examinations and related communications between regulatory agencies and the entity and, when appropriate, making inquiries of the regulatory agencies, including inquiries about examinations in progress.

Audit Objectives

6.43 As noted in paragraph 6.22, the *Compliance Supplement* contains the audit objectives for each type of compliance requirement that the auditor should consider in planning and performing tests of compliance requirements. The audit objectives are useful in understanding the specific objectives to be satisfied when the auditor performs audit tests and determines whether the noncompliance that is identified is material.

Suggested Audit Procedures

6.44 The *Compliance Supplement* contains suggested audit procedures for testing federal programs for compliance. These suggested audit procedures represent procedures that may be used by the auditor in developing an audit program. The suggested audit procedures may also be useful in testing the same types of compliance requirements for programs that are not included in the *Compliance Supplement*. These suggested audit procedures represent a tool available to the auditor; however, the auditor is neither required to follow these audit procedures nor restricted to using only these procedures. The auditor should use professional judgment in determining the appropriate audit procedures to be performed to allow him or her to obtain sufficient evidence to form an opinion on the auditee's compliance with the compliance requirements that could have a direct and material effect on each major program.

Audit Sampling

6.45 The auditor generally uses audit sampling to obtain evidential matter. There are two approaches to audit sampling: nonstatistical and statistical. Circular A-133 does not require any particular sampling approach in a single audit. The factors to be considered in planning, designing, and evaluating audit samples (including planning a particular sample for a test of controls) are discussed in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350). When planning to test a particular sample of transactions,

the auditor should consider the specific audit objective to be achieved and should determine that the audit procedure, or combination of procedures, to be applied will achieve that objective. The size of a sample necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. Auditors should note that SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, and Circular A-133 require the auditor to determine both the known questioned costs and likely questioned costs associated with audit findings. The determination of likely questioned costs may require the projection of sample results to determine whether a finding is required to be reported in the schedule of findings and questioned costs. Circular A-133 does not require the auditor to report an exact amount or a statistical projection of likely questioned costs, but rather to include an audit finding when the auditor's estimate of likely questioned costs is greater than \$10,000. See paragraph 6.59 for a further discussion of likely questioned costs.

6.46 The AICPA Audit and Accounting Guide *Audit Sampling* provides guidance to help auditors apply audit sampling in accordance with SAS No. 39. In the Audit Guide, sampling in compliance tests of internal controls and in substantive tests of details, as well as dual-purpose testing is discussed.

Using Separate Samples for Each Major Program

6.47 Although the auditor must obtain sufficient evidence to support an opinion on compliance for each major federal program, separate samples for each major program are not required. Experience has shown, however, that it is preferable to select separate samples from each major program because the separate sample provides clear evidence of the tests performed, the results of those tests, and the conclusions reached. If the auditor chooses to select audit samples from the entire universe of major program transactions, the working papers should be presented in such a fashion that they clearly indicate that the results of such samples, together with other audit evidence, are sufficient to support the opinion on each major program's compliance. As noted in paragraph 6.37, the auditor should be aware that a sample of a few items with a low dollar value and from a large population, generally does not, by itself, provide sufficient evidence.

Consideration of Subsequent Events

6.48 The auditor's consideration of subsequent events in a compliance audit is similar to the auditor's consideration of subsequent events in a financial statement audit, as outlined in SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560). The auditor should consider information about events relating to the applicable compliance requirements that comes to his or her attention after the end of the audit period and prior to the issuance of his or her report.

6.49 Two types of subsequent events require consideration by management and evaluation by the auditor. The first type consists of events that provide additional information about the entity's compliance during the audit period. For the period from the end of the audit period to the date of the auditor's report, the auditor should perform procedures to identify such events. These procedures should include, but may not be limited to, inquiries about and consideration of the following information:

- Relevant internal auditors' reports issued during the subsequent period

- Other auditors' reports identifying noncompliance that were issued during the subsequent period
- Regulatory agencies' reports on the entity's noncompliance that were issued during the subsequent period
- Information about the entity's noncompliance, obtained through other professional engagements for that entity

6.50 The second type of subsequent events consists of noncompliance that occurs subsequent to the audit period but before the date of the auditor's report. The auditor has no responsibility to detect such noncompliance. However, should such noncompliance come to the auditor's attention, it may be of such a nature and significance that the auditor should consider whether the matter is adequately disclosed in the notes to the schedule of expenditures of federal awards.

Evaluation and Reporting of Noncompliance

Instances of Noncompliance (Findings)

6.51 The auditor's tests of compliance with compliance requirements may disclose instances of noncompliance. Circular A-133 refers to these instances of noncompliance as "findings." Such findings may be of a monetary nature and involve questioned costs or may be nonmonetary and not result in questioned costs. Both *Government Auditing Standards* and Circular A-133 specify how certain findings should be reported. The auditor's opinion on compliance and his or her responsibilities for reporting findings are discussed in greater detail in chapter 10.

Compliance Opinion

6.52 Circular A-133 requires the auditor to report on compliance, which includes an opinion or disclaimer of opinion (on each major program) on whether the auditee complied with the applicable compliance requirements, and to prepare a schedule of findings and questioned costs (see paragraphs 10.41 through 10.46 and 10.55 through 10.67 for a further discussion). In evaluating whether the auditee complied with the compliance requirements in all material respects, the auditor should consider (a) the nature and frequency of the noncompliance identified, and (b) whether such noncompliance is material relative to the nature of the compliance requirements. Assessing materiality at the appropriate level is critical to the proper evaluation of findings. Materiality as it relates to giving an opinion on the auditee's compliance is discussed in paragraphs 6.13 through 6.16. The auditor's evaluation of the effect of questioned costs on the compliance opinion is discussed in paragraph 6.55.

Financial Statement Impact

6.53 The auditor also has the responsibility of assessing the impact of the actual and projected error noted in the single audit against the materiality level established for the basic financial statements (see paragraph 6.16). The auditor should consider the effect of (a) any contingent liability that may arise from the noncompliance in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and (b) for nongovernmental entities, any uncertainty regarding the resolution of instances of noncompliance in accordance with SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

Questioned Costs

6.54 Questioned costs are defined by Circular A-133 to include costs that are questioned by the auditor because of an audit finding (a) that resulted from a violation or possible violation of a provision of a law, regulation contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds, (b) for which the costs, at the time of the audit, are not supported by adequate documentation, or (c) for which the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

Evaluating the Effect of Questioned Costs on the Compliance Opinion

6.55 In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of the total costs questioned for each major program (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). There may be instances in which the known questioned costs are not considered material but the likely questioned costs are considered material. In this situation, the auditor should consider the noncompliance to be material or may expand the scope of the audit and apply additional audit procedures to further establish the likely questioned costs. For example, if an auditor's sample results in known questioned costs related to three sample items out of thirty selected, the three errors may not be considered material. However, the auditor's projection of those errors to the entire population may suggest that there are likely questioned costs that are material. In this example, the auditor should consider the noncompliance to be material and should report a finding or expand the scope of the audit and apply additional audit procedures.

Federal Agency Consideration of Findings and Questioned Costs

6.56 The auditor's designation of a cost as questioned does not necessarily mean that a federal grantor agency will disallow the cost. In most instances, the auditor is unable to determine whether a federal awarding agency or pass-through entity will ultimately disallow a questioned cost, because the agency or entity has considerable discretion in these matters.

6.57 Circular A-133 defines a management decision as the evaluation by the federal awarding agency or pass-through entity of the audit findings and corrective action plan (see paragraphs 2.26 and 10.68 through 10.70 for a further discussion of the corrective action plan) and the issuance of a written decision as to what corrective action is necessary. Circular A-133 allows a federal awarding agency or pass-through entity receiving an auditor's report indicating findings and questioned costs six months after receipt of the audit report to issue such a decision. The nature of the questioned costs, as well as the amounts involved, are considered by the awarding agency or pass-through entity in issuing a management decision and deciding whether to disallow them. In addition, most federal awarding agencies have established appeal and adjudication procedures for questioned costs. Because of the discretion allowed in resolving these matters, all questioned costs are subject to uncertainty regarding their resolution.

Reporting the Findings

6.58 Circular A-133 requires the auditor to consider a different level of materiality for the purposes of reporting audit findings (see paragraphs 3.36

through 3.38 for a further discussion). Circular A-133 requires the auditor, in addition to providing an opinion on compliance, to include the following items, among other things, in the schedule of findings and questioned costs (see paragraph 10.56 for a complete listing of the items that are required to be included):

- Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement*.
- Known questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program (see paragraph 6.22 for a listing of the fourteen types of compliance requirements). Known questioned costs are those specifically identified by the auditor.
- Known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement.
- Known questioned costs that are greater than \$10,000 for a federal program that is not audited as a major program (see paragraph 10.63 for a further discussion).

The reporting of findings is discussed in greater detail in paragraphs 10.63 and 10.64.

Reporting the Likely Questioned Costs

6.59 As noted before, in evaluating the effect of questioned costs on the opinion on compliance, the auditor considers both known questioned costs and the best estimate of the total costs questioned (likely questioned costs) for each major program. Known and likely questioned costs also need to be considered when audit findings are reported. In addition to reporting known questioned costs greater than \$10,000 in the schedule of findings and questioned costs, the auditor is also required to report known questioned costs when likely questioned costs are greater than \$10,000. For example, if the auditor specifically identifies \$7,000 in questioned costs but, based on his or her evaluation of the effect of questioned costs on the opinion on compliance, the auditor estimates that the total questioned costs are in the \$50,000–\$60,000 range, the auditor would report a finding that indicates the known questioned costs of \$7,000. See paragraph 10.63 for a further discussion.

Findings That Cannot Be Quantified

6.60 The auditor may discover instances of noncompliance that cannot be quantified. The auditor's responsibility for reporting such findings can best be described through an example. Assume that the auditor encounters a pass-through entity that consistently fails to provide its subrecipients with federal award information. Circular A-133 requires the auditor to consider all findings in relation to a type of compliance requirement (in the example provided, subrecipient monitoring is the relevant type of compliance requirement) or an audit objective identified in the *Compliance Supplement*. The pertinent audit objective included in the *Compliance Supplement* and relating to the example provided here is for the auditor to “determine whether the pass-through entity identifies federal award information and compliance requirements to the subrecipient.” Because the pass-through entity failed to provide federal award

information to its subrecipients, this noncompliance would be material in relation to the audit objective and, therefore, should be reported as an audit finding. In addition, the auditor should also consider whether reportable conditions exist and require reporting with respect to subrecipient monitoring.

Performing Follow-Up Procedures

Auditee Responsibilities for Audit Follow-Up and for the Summary Schedule of Prior Audit Findings

6.61 Circular A-133 states that the auditee is responsible for follow-up and corrective action on all audit findings. The follow-up required by Circular A-133 is facilitated by the requirement that the auditee prepare a summary schedule of prior audit findings (see paragraphs 2.21 and 10.68). This schedule reports the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards. It also includes audit findings reported in the prior audit's summary schedule of prior audit findings that were not identified as either (1) fully corrected, (2) no longer valid, or (3) not warranting further actions. Circular A-133 states that a valid reason for considering an audit finding as not warranting further action is that *all* of the following have occurred:

- Two years have passed since the audit report in which the finding occurred was submitted to the federal clearinghouse.
- The federal agency or pass-through entity is not currently following up with the auditee on the audit finding.
- A management decision was not issued.

6.62 Circular A-133 also states the following with regard to the auditee's schedule of prior audit findings:

- When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.
- When audit findings were not fully corrected or were only partially corrected, the summary schedule must describe the planned corrective action as well as any partial corrective action taken.
- When the corrective action taken is significantly different from the corrective action previously reported in a corrective action plan or in the federal agency's or pass-through entity's management decision, the summary schedule must provide an explanation.
- When the auditee believes the audit findings are no longer valid or do not warrant further actions, the reasons for this position must be described in the summary schedule (see paragraph 6.61).

Auditor Responsibilities for Follow-Up on Previously Reported Findings

6.63 Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor should also perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year. The auditor's reporting responsibilities are further discussed in chapter 10.

Auditor Follow-Up Procedures

6.64 To follow up on previous audit findings, the auditor should obtain the auditee's summary schedule of prior audit findings and should review its contents with appropriate members of management. Although in many cases the procedures performed in the current audit will provide a basis for the auditor to assess the schedule, the auditor may find it necessary to perform procedures directed specifically at the status of prior audit findings. In these cases, the following procedures are to be considered:

- Inquiry of auditee management and program personnel
- Review of management decisions issued by federal awarding agencies or pass-through entities to the auditee (see paragraph 6.57)
- Observation of an activity that has been redesigned to address a prior-year finding
- Testing of similar current-year transactions

Audit Follow-Up for Findings Reported, as Required by Government Auditing Standards

6.65 As noted in paragraph 3.14, *Government Auditing Standards* establishes an additional fieldwork standard, which requires the auditor to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit to determine whether the auditee has taken timely and appropriate corrective actions. The auditee's schedule of prior audit findings is only required to include the status of prior-year findings relative to federal awards. However, there may be certain financial statement audit findings required to be reported under *Government Auditing Standards* that are included in the summary schedule of prior audit findings (because they also relate to federal awards). Also, although not required, some auditees may decide to include the status of other financial statement audit findings (that is, those that are not related to federal awards) in the schedule. For those financial statement audit findings included in the summary schedule of prior audit findings, the auditor's assessment of the reasonableness of the schedule (described in paragraphs 6.63 and 6.64) would meet the audit follow-up requirements of *Government Auditing Standards*. For financial statement audit findings that are not included in the schedule, the auditor should follow up on the findings to determine their status. See paragraph 10.62 for a discussion of the auditor's responsibility to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

Corrective Action Plan

6.66 Circular A-133 also requires that upon completion of the audit, the auditee prepare a corrective action plan that identifies the contact person responsible for corrective action, indicates the corrective action planned, the anticipated completion date or, if the auditee does not agree with the finding, an explanation and specific reasons why the auditee disagrees. The auditor may find the auditee's corrective action plan useful in performing audit follow-up (in addition to the auditee's summary schedule of prior audit findings) because it may provide a preliminary indication of the corrective steps planned by the auditee.

Disputes or Unresolved Findings

6.67 There may be times when, as part of the follow-up on prior findings, the auditor determines that (a) a previous finding is the subject of a dispute

between the auditee and the federal awarding agency or pass-through entity or (b) the federal awarding agency or pass-through entity has not addressed the finding by issuing a management decision. In these situations, if the finding relates to a current-year major program, the auditor should report similar transactions of the current year as findings and questioned costs until either the dispute is resolved or the initial finding no longer warrants further action under Circular A-133 as described in paragraph 6.61. However, if the auditor no longer believes that there is noncompliance because of additional evidence obtained in the current year, similar transactions need not be reported as findings.

Management Representations Related to Federal Awards

6.68 As part of an audit under Circular A-133, the auditor should obtain written representations from management about matters related to federal awards. Therefore, in addition to the management representations obtained in connection with an audit of the financial statements as discussed in paragraph 4.40, the auditor should obtain written representations from management concerning the identification and completeness of federal award programs, representations concerning compliance with compliance requirements, and identification of known instances of noncompliance.

Suggested Representations

6.69 The auditor should consider obtaining the following written representations in a single audit:²

- Management is responsible for complying, and has complied, with the requirements of Circular A-133.
- Management has prepared the schedule of expenditures of federal awards in accordance with Circular A-133 and has included expenditures made during the period being audited for all awards provided by federal agencies in the form of grants, federal cost-reimbursement contracts, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance.
- Management is responsible for complying with the requirements of laws, regulations, and the provisions of contracts and grant agreements related to each of its federal programs.
- Management is responsible for establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on its federal programs.
- Management has identified and disclosed to the auditor the requirements of laws, regulations and the provisions of contracts and grant agreements that are considered to have a direct and material effect on each federal program.

² These representations may be added to a representation letter obtained in connection with an audit of the financial statements instead of a separate letter.

- Management has made available all contracts and grant agreements (including amendments, if any) and any other correspondence that have taken place with federal agencies or pass-through entities and are related to federal programs.
- Management has complied, in all material respects, with the compliance requirements in connection with federal awards except as disclosed to the auditor.
- Management has identified and disclosed to the auditor all amounts questioned and any known noncompliance with the requirements of federal awards, including the results of other audits or program reviews.
- Management's interpretations of any compliance requirements that have varying interpretations have been provided.
- Management has made available all documentation related to the compliance requirements, including information related to federal program financial reports and claims for advances and reimbursements.
- Federal program financial reports and claims for advances and reimbursements are supported by the books and records from which the basic financial statements have been prepared, and are prepared on a basis consistent with that presented in the schedule of expenditures of federal awards.
- The copies of federal program financial reports provided to the auditor are true copies of the reports submitted, or electronically transmitted, to the federal agency or pass-through entity, as applicable.
- If applicable, management has monitored subrecipients to determine that they have expended pass-through assistance in accordance with applicable laws and regulations and has met the requirements of Circular A-133.
- If applicable, management has issued management decisions on a timely basis after their receipt of subrecipients' auditor's reports that identified noncompliance with laws, regulations, or the provisions of contracts or grant agreements, and has ensured that subrecipients have taken the appropriate and timely corrective action on findings.
- If applicable, management has considered the results of subrecipient audits and has made any necessary adjustments to their own books and records.
- Management is responsible for and has accurately prepared the summary schedule of prior audit findings to include all findings required to be included by Circular A-133.
- Management has provided the auditor with all information on the status of the follow-up on prior audit findings by federal awarding agencies and pass-through entities, including all management decisions.
- Management has accurately completed the appropriate sections of the data collection form.
- If applicable, management has disclosed all contracts or other agreements with the service organizations.
- If applicable, management has disclosed to the auditor all communications from the service organization relating to noncompliance at the service organization.

- Management has disclosed any known noncompliance occurring subsequent to the period for which compliance is audited.
- Management has disclosed whether any changes in internal control over compliance or other factors that might significantly affect internal control, including any corrective action taken by management with regard to reportable conditions (including material weaknesses), have occurred subsequent to the date as of which compliance is audited.

Refusal to Furnish Written Representation

6.70 Management's refusal to furnish all written representations that the auditor considers necessary in the circumstances constitutes a limitation on the scope of the audit sufficient to require a qualified opinion or disclaimer of opinion on the auditee's compliance with major program requirements. The auditor should also consider the effects of management's refusal on his or her ability to rely on other management representations.

State and Local Government Compliance Auditing Considerations

6.71 An auditor may also be engaged to test and report on compliance with state and local laws and regulations in addition to the testing and reporting requirements imposed by *Government Auditing Standards* and Circular A-133. Although such auditing is outside the scope of this SOP, such a requirement may specify compliance tests, similar to those in a single audit. When this is the case, auditors should consult state or local government officials or other sources concerning the nature and scope of the required testing. However, state or local government funds should be distinguished from pass-through federal funds. When a single audit is conducted, pass-through federal funds are considered part of the federal awards received. See paragraphs 3.47 through 3.49 for a brief discussion of state and local compliance requirements.

Chapter 7

DETERMINATION OF MAJOR PROGRAMS

7.1 As noted in paragraph 2.22, Circular A-133 requires the auditee to identify in its accounts all federal awards received and expended and the federal programs under which they were received. The auditee is also required to prepare a schedule of expenditures of federal awards for the period covered by its financial statements (see chapter 5 for a further discussion of the requirements related to this schedule). However, Circular A-133 places the responsibility for identifying major programs on the auditor, and it provides the criteria to be used in applying a risk-based approach to determining major programs. The risk-based approach is designed to focus the single audit on higher-risk programs. See paragraph 7.20 for a description of when the auditor can deviate from the use of risk criteria.

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

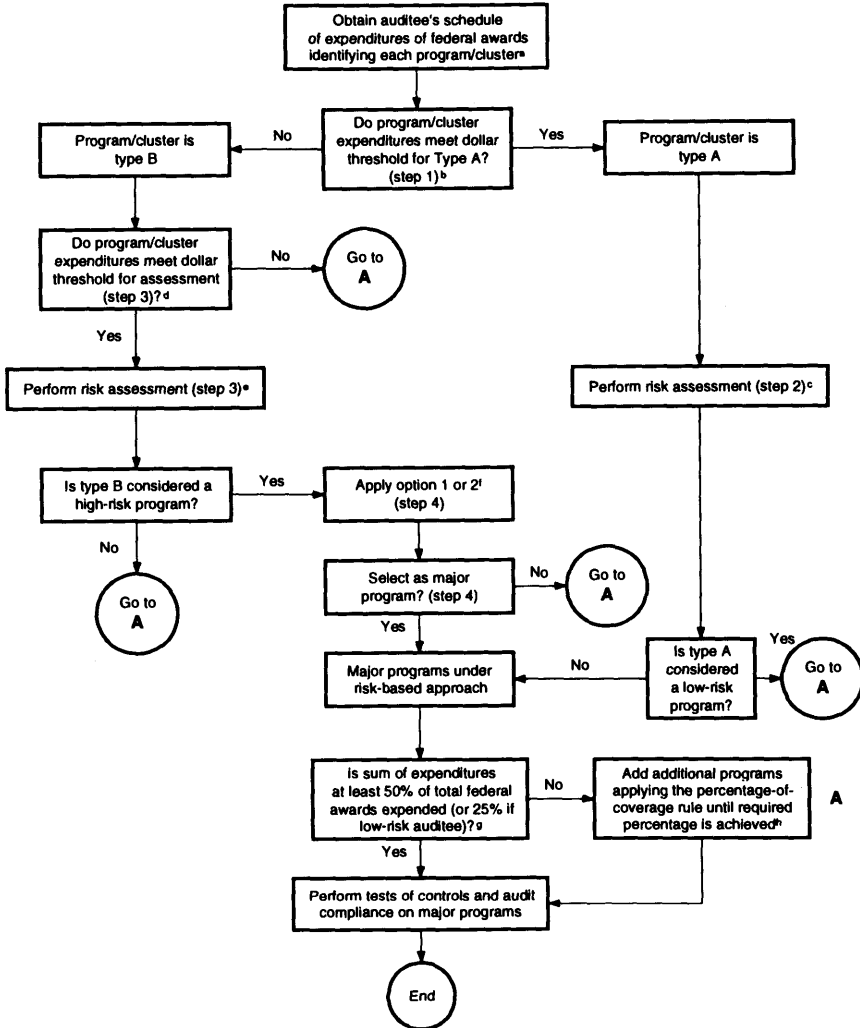
Applying the Risk-Based Approach

7.3 The guidance on the risk-based approach is organized here as provided in Circular A-133 and consists of the following steps (see table 7.1 for a flowchart illustration of applying the risk-based approach for determining major programs):

- Step 1—determination of type A and type B programs (paragraphs 7.4 through 7.9)
- Step 2—identification of low-risk type A programs (paragraphs 7.10 through 7.13)
- Step 3—identification of high-risk type B programs (paragraphs 7.14 through 7.16)
- Step 4—determination of programs to be audited as major (paragraphs 7.17 through 7.20)

Exhibit 7.1

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



-
- a. See paragraph 1.18 for the definition of federal programs, including clusters.
 - b. See paragraphs 7.4 through 7.9 for a detailed discussion of step 1.
 - c. See paragraphs 7.10 through 7.13 for a detailed discussion of step 2.
 - d. See paragraphs 7.14 through 7.16 for a detailed discussion of step 3.
 - e. Before performing the risk assessment, the auditor should consider whether option 1 or option 2 will be selected under step 4 because it will affect whether risk assessments need to be performed on all type B programs or only some type B programs. See paragraph 7.15.
 - f. The number of type B high-risk programs identified as major programs is either—
 - *Option 1:* one-half of the number of type B high-risk programs, unless this number exceeds the number of low-risk type A programs identified in step 2. In this case, the auditor would be required to audit as major the same number of high-risk type B programs as low-risk type A programs. Under this option, the auditor is expected to perform risk assessments on all type B programs that exceed the threshold for type B.
 - *Option 2:* one high-risk program for each low-risk type A program. This option does not require the auditor to perform risk assessments on all type B programs. See paragraphs 7.17 through 7.20 for a detailed discussion of step 4, including option 1 and option 2.
 - g. There may be instances when the auditee includes certain noncash assistance (such as loan guarantees or loans) in the notes to the schedule of expenditures of federal awards (see paragraph 5.13). The auditor should be sure to include such noncash assistance as part of total federal awards expended when performing this calculation.
 - h. The additional programs/clusters selected (marked "A" on the flowchart) to meet the percentage-of-coverage rule are audited as major programs in addition to type A and type B programs identified in steps 1 through 4. See paragraph 7.24 for a further discussion of the percentage-of-coverage rule.

Step 1—Determination of Type A and Type B Programs

7.4 To determine which federal programs are to be audited as major (see step 4), the auditor must first identify federal programs as being either type A or type B as defined in Circular A-133. In general, type A programs are larger federal programs and type B programs are smaller federal programs. The auditor should obtain the schedule of expenditures of federal awards from the auditee to assist in the identification of type A and type B programs. The schedule of expenditures of federal awards, prepared by the auditee, includes all cash and noncash awards either on the face of the schedule or in the notes to the schedule. Auditors should note that for purposes of determining major programs, a cluster of programs should be considered as one program (see paragraphs 1.18, 1.19, 2.18, 5.6, and 8.30 for a further discussion of a cluster of programs).

Type A Program Criteria

7.5 The larger federal programs are labeled as type A. The criteria that Circular A-133 establishes for identifying Type A programs are presented in table 7.1.

Table 7.1**Criteria for Identifying Type A Programs**

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

* Includes both cash and noncash awards.

Type B Program Criteria

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

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

7.7 The various types of noncash awards, including loans and loan guarantees, and how they are valued are discussed in chapter 5. Circular A-133 states that when the auditor applies the dollar criteria shown in table 7.1 to identify type A programs, the inclusion of large loans and loan guarantees should not result in the exclusion of other federal programs as type A programs. Auditors should note that this requirement relates only to loans and loan guarantees and not to any other large noncash awards. When a federal program providing loans or loan guarantees *significantly affects* the number or size of type A programs, the auditor should consider the loan or loan guarantee program a type A program and exclude its values in determining other type A programs. The auditor should use professional judgment in determining whether type A programs would be *significantly affected* in this situation.

7.8 The example in table 7.2 demonstrates this concept by showing the identification of type A programs as well as the effect of loans and loan guarantees on that identification process.

Table 7.2

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

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

* In accordance with Circular A-133, loans and loan guarantees include new loans made during the year, plus prior-year loans for which the federal government imposes continuing compliance requirements, plus any interest subsidy, cash, or administrative cost allowance received. See paragraphs 5.14 and 5.15 for additional information.

7.9 In table 7.2 the auditee has \$97,600,000 in total federal awards expended. Therefore, an application of the criteria in table 7.1 would indicate that type A programs would be those that expended federal awards equal to or greater than \$2,928,000 (3 percent of \$97,600,000), or programs B, F, and G. However, when large loan and loan guarantee programs F and G are excluded from the base amount of the total federal awards expended in the calculation, the type A programs would be those programs that expended federal awards equal to or greater than \$300,000 (the larger of \$213,000 [3 percent of \$7,100,000], or \$300,000). Therefore, under the second calculation programs A, B, D, E, F, and G would be type A programs. If the auditor, in his or her professional judgment, concludes that the difference in the number or size of type A programs is significantly affected by the inclusion of the loans and loan guarantees (which in this example would be likely due to the significant increase in type A programs), the auditor would identify programs A, B, D, E, F, and G as type A programs. The auditor should consider contacting the cognizant or oversight agency for audit if the auditor is unsure about whether to exclude loan or loan guarantees when determining type A programs.

Step 2—Identification of Low-Risk Type A Programs

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

General Conditions for Low-Risk Type A Programs

7.11 Type A programs may generally be considered low-risk if both of the following conditions are met: (a) the program has been audited as a major program

in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and (b) in the most recent audit period, the *program* had no audit findings (see paragraph 10.63 for a description of audit findings).

Auditor Judgment in Determination of Low-Risk Type A Programs

7.12 Circular A-133 permits the auditor to conclude, based on professional judgment, that a type A program is low-risk even though (a) in the prior audit period it may have had known or likely questioned costs greater than \$10,000 for a type of compliance requirement, (b) known fraud has been identified, or (c) the summary schedule of prior audit findings materially misrepresents the status of a prior audit finding. For example, consider a situation in which the funds expended under a federal program in the prior year totaled \$10 million, there were known questioned costs of \$11,000 that related to one isolated instance, and there were no additional likely questioned costs. In this example, the auditor, based on professional judgment, could decide that the program is low-risk in the current year. In making the final determination of whether a type A program is low-risk, the auditor should also consider the risk criteria in paragraphs 7.26 through 7.36, the results of audit follow-up, and whether any changes in the personnel or systems affecting a type A program have significantly increased its risk. Based on all of this information, the auditor would apply professional judgment in determining whether a type A program is low-risk.

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

7.13 A federal awarding agency may request that a type A program for certain recipients not be considered low-risk so that it would be audited as a major program. For example, it may be necessary for a large type A program to be audited as major each year for particular recipients, to allow the federal agency to comply with the Government Management Reform Act of 1994. In this instance, Circular A-133 requires the federal awarding agency to obtain approval from the OMB. Furthermore, the federal awarding agency must notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year end to be audited. (See also paragraph 7.35 for a discussion of the federal agency or pass-through entity option to identify federal programs as higher risk in the *Compliance Supplement*.)

Step 3—Identification of High-Risk Type B Programs

7.14 After completing steps 1 and 2, the auditor should identify type B programs that are high-risk, using professional judgment and the risk criteria discussed in paragraphs 7.26 through 7.36. Except for known reportable conditions in internal control or instances of noncompliance, a single risk criteria would, in general, seldom cause a type B program to be considered high-risk.

7.15 Before beginning step 3, the auditor should—

- a. Consider whether there are low-risk type A programs. When there are no type A programs identified as low-risk (either because there are no type A programs or because none of the type A programs are low-risk), the auditor is not required to perform step 3. Instead, the auditor would audit as major enough type B programs to meet the

percentage-of-coverage rule (see paragraph 7.24). When there are type A programs, but none are low-risk, the auditor would audit as major all type A programs plus any additional type B programs needed to meet the percentage-of-coverage rule. In either case, any programs requested to be audited by a federal agency or pass-through entity must be audited as a major program and would be included in determining whether the percentage-of-coverage rule has been met (see paragraph 7.21).

- b. Consider whether option 1 or option 2 will be used in step 4 (see paragraphs 7.18 through 7.19 for a detailed description of each option). The auditor's decision of which option to choose will likely be based on audit efficiency and will affect how many type B programs are subject to risk assessment. The auditor should consider the following discussion before deciding whether to use option 1 or option 2.
- Under option 1, the auditor is required to perform a risk assessment on all type B programs (excluding small type B programs as discussed in paragraph 7.16). In comparison with option 2, option 1 will likely require the auditor to perform more type B program risk assessments, but may also result in the auditor having to audit fewer major programs. For example, assume that an auditee has four low-risk type A programs and ten type B programs that exceed the amount specified in table 7.3. Also assume that the auditor chooses option 1. In this scenario, the auditor would be required to perform a risk assessment on all type B programs. If the auditor finds that only four type B programs are high-risk, the auditor would only be required to audit two of the four high-risk type B programs as major (one-half of the number of high-risk type B programs).
 - Under option 2, the auditor is only required to identify high-risk type B programs up to the number of low-risk type A programs. In comparison with option 1, option 2 will likely require the auditor to perform fewer type B risk assessments, but may also result in the auditor having to audit more major programs. For example, assume that an auditee has four low-risk type A programs and ten type B programs that exceed the amount specified in table 7.3. Assume also that the first four type B programs subject to risk assessment are determined by the auditor to be high-risk. In this scenario, the auditor may choose option 2, identify the four high-risk type B programs as major, and not perform risk assessments on the remaining six type B programs. Using the same example but assuming that the auditee only has one low-risk type A program (instead of four), the auditor would be required to audit one type B program as major under either option 1 or 2. In this scenario, option 2 would likely be the most efficient choice for the auditor since the auditor would only need to perform type B program risk assessments until one high-risk type B program was identified (under option 1 the auditor would be required to perform a risk assessment on all type B programs).

Criteria for Performing Risk Assessments on Type B Programs

7.16 An auditor is not expected to perform risk assessments on relatively small federal programs. Therefore, Circular A-133 only requires the auditor to

perform risk assessments on type B programs that exceed the larger of the criteria shown in table 7.3.

Table 7.3

Criteria for Performing Risk Assessments on Type B Programs

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

* Includes both cash and noncash awards.

Step 4—Determination of Programs to Be Audited as Major

Criteria for Major Programs

7.17 After completing steps 1 through 3, the auditor identifies the major programs. At a minimum, Circular A-133 requires the auditor to audit all of the following as major programs:

- All type A programs, except those identified as low-risk under step 2 (see paragraphs 7.10 through 7.13)
- High-risk type B programs as identified under either of the two options described in paragraph 7.18
- Programs to be audited as major based on a federal agency request (in lieu of the federal agency conducting or arranging for additional audits; see paragraph 7.21 for further information)
- Additional programs, if any, that are necessary to meet the percentage-of-coverage rule described in paragraph 7.24

Two Options Available for Identifying High-Risk Type B Programs

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

- *Option 1.* Under option 1, the auditor is expected to perform risk assessments of all type B programs that exceed the amount specified in table 7.3, and to audit at least one-half of the high-risk type B programs as major, unless this number exceeds the number of low-risk type A programs identified in step 2 (that is, the cap). In this case, the auditor would be required to audit as major the same number of high-risk type B programs as the cap. For example, consider an auditee that has ten low-risk type A programs, and fifty type B programs above the amount specified in table 7.3. Under this option, the auditor would be required to perform risk assessments of the fifty type B programs. Assume that based on that assessment, the auditor determines that there are twenty-five high-risk type B programs. One-half of the twenty-five high-risk type B programs is 12.5, which rounds up to thirteen programs. Under this option, the auditor would audit thirteen of the high-risk type B programs as major; however, since the cap in this example is ten (that is, the number of low-risk type A programs), the auditor is only required to audit ten high-risk type B programs as major.

- *Option 2.* Under option 2, the auditor is only required to audit as major one high-risk type B program for each type A program identified as low-risk in step 2. Under this option the auditor would not be required to perform risk assessments for any type B program when there are no low-risk type A programs (that is, the cap is zero). Continuing with the previous example, under option 2 the auditor would perform risk assessments of type B programs until ten high-risk programs are identified (that is, ten is the number of low-risk type A programs). The auditor would then audit as major the ten type B programs identified as high-risk. Depending on the order in which risk assessments on type B programs are performed, the auditor might only need to perform risk assessments of ten type B programs determined to be high-risk, or the auditor may need to perform risk assessments on additional Type B programs until ten high-risk programs are identified.

7.19 The auditor may choose option 1 or option 2. There is no requirement to justify the reasons for selecting either option. The results under options 1 and 2 may vary significantly, depending on the number of low-risk type A programs and high-risk type B programs (see paragraph 7.15). Circular A-133 encourages the auditor to use an approach that provides an opportunity for different high-risk type B programs to be audited as major over a period of time.

Deviation From Use of Risk Criteria

7.20 For first-year audits, Circular A-133 allows auditors to deviate from the above-described risk assessment process. A first-year audit is defined as the first year an entity is audited under the June 30, 1997, revision to Circular A-133 or as the first year of a change in auditors. This exception allows the auditor to elect to determine major programs as all type A programs plus any type B programs as are necessary to meet the percentage-of-coverage rule described in paragraph 7.24. Under this option, the auditor is not required to perform steps 2, 3, and 4. However, to ensure that a frequent change of auditors would not preclude the audit of high-risk type B programs, this election for first-year audits may not be used more than once every three years. Auditors should consider whether this exception is an option during the planning phase of the single audit (see also paragraphs 3.28 and 3.29 for a discussion of initial-year audit considerations).

Other Considerations Regarding the Risk-Based Approach

Federal Agency Requests for Additional Major Programs

7.21 A federal agency may request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach and, if it would not, informing the agency of the estimated incremental cost. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based on the

federal agency's request, and the federal agency agrees to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach may also be used by pass-through entities for a subrecipient.

Documentation of Risk Assessment in the Working Papers

7.22 Circular A-133 requires the auditor to document in the working papers the risk assessment process used in determining major programs. It is therefore necessary for the auditor to document adequately, as required by GAAS and *Government Auditing Standards*, the determination of major programs (see the discussion of working paper requirements in paragraphs 3.16 through 3.18 and 3.22 through 3.23).

Auditor Judgment in the Risk Assessment Process

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

Percentage-of-Coverage Rule

7.24 Circular A-133 requires the auditor to audit, as major programs, federal programs with federal awards expended that, in the aggregate, encompass at least 50 percent of the total federal awards expended. However, if the auditee meets the criteria for a low-risk auditee (see paragraph 7.25), the auditor is only required to audit as major programs federal programs with federal awards expended that, in the aggregate, encompass at least 25 percent of the total federal awards expended. To comply with this requirement, the auditor should compute the total federal awards expended for the major programs, determined under step 4, as a percentage of the total federal awards expended. If the total does not equal 50 percent (or 25 percent in the case of a low-risk auditee) of the total federal awards expended, the auditor should select additional programs (either type A or type B) to equal 50 percent (or 25 percent in the case of a low-risk auditee) and test them as major programs. The selection of additional programs to meet the percentage of coverage is based on the auditor's professional judgment. When selecting additional programs to meet the percentage-of-coverage rule, the auditor may select programs without regard to risk assessment. If loans or loan guarantees are major programs, these programs may be used for purposes of meeting the percentage-of-coverage rule. Furthermore, when a federal agency or pass-through entity requests and pays for a program to be audited as major (see paragraph 7.21), that program may also be used for purposes of meeting the percentage-of-coverage rule.

Low-Risk Auditee Criteria

7.25 Circular A-133 establishes certain conditions for determining whether an auditee is low-risk. An auditee that meets all of the following con-

ditions for each of the preceding two years (or in the case of biennial audits, the preceding two audit periods) qualifies as a low-risk auditee and is eligible for the reduced audit coverage discussed in paragraph 7.24:

- a. Single audits were performed on an annual basis in accordance with Circular A-133. An auditee that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.
- b. The auditor's opinions on the financial statements and the schedule of expenditures of federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of federal awards and may provide a waiver.
- c. There were no deficiencies in internal control over financial reporting that were identified as material weaknesses under the requirements of *Government Auditing Standards*. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of federal awards and may provide a waiver.
- d. None of the federal programs had audit findings from any of the following in either of the preceding two years (or in the case of biennial audits, the preceding two audit periods) in which they were classified as type A programs:
 - Material weaknesses in the internal control over compliance
 - Noncompliance with the provisions of laws, regulations, contracts, or grant agreements that have a material effect on the type A program
 - Known or likely questioned costs that exceed 5 percent of the total federal awards expended for a type A program during the year

Criteria for Federal Program Risk

7.26 The auditor's risk assessment should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the federal program being evaluated. Circular A-133 indicates that the auditor should use professional judgment and consider certain criteria to identify risk in federal programs. As a part of the risk assessment, the auditor may also wish to discuss a particular federal program with auditee management and with the federal agency or pass-through entity. The criteria for federal program risk that are identified in Circular A-133 are discussed in the following sections.

Current and Prior Audit Experience

7.27 The auditor should consider his or her prior experience with the auditee and the results of audits performed in the past. The following specific factors that should be considered:

- Weaknesses in the internal control over compliance for federal programs (paragraph 7.28)
- Federal programs administered under multiple internal control structures (paragraph 7.29)

- A weak system for monitoring subrecipients when significant parts of federal programs are passed through to subrecipients (paragraph 7.30)
- The extent to which computer processing is used (paragraph 7.31)
- Prior audit findings (paragraph 7.32)
- Federal programs not recently audited as major (paragraph 7.33)

Weaknesses in Internal Control Over Federal Programs

7.28 In assessing program risk, the auditor should consider internal control over compliance for federal programs (see chapter 8 for detailed guidance on internal control over compliance for federal programs). Weak internal control over compliance for federal programs is an indication of higher risk. Consideration should also be given to the control environment over federal programs and to such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements. The auditor may also consider the competence and experience of the personnel who administer federal programs. In instances in which the staff are new or do not have experience with a program, consideration should be given to assessing the program at a higher level of risk.

Federal Programs Administered Under Multiple Internal Control Structures

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

Weak System for Monitoring Subrecipients

7.30 Consideration should be given to the extent that federal programs are passed through to subrecipients. If the auditee passes a significant portion of a federal program to subrecipients and the auditor has identified that the auditee has a weak system for monitoring subrecipients, the auditor should consider assigning a higher risk to the program. Alternatively, if the auditee passes a significant portion of programs to subrecipients and the auditee has an effective system in place to monitor the subrecipients, the auditor should consider assigning a lower level of risk to the program.

Extent to Which Computer Processing Is Used

7.31 When assessing risk, the auditor should consider the extent to which computer processing is used to administer federal programs, as well as the complexity of that processing. A complex system does not always indicate higher risk. On the other hand, a newly installed system that has not been tested in the past, or a recently modified system, may indicate higher risk. Auditors should refer to SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to SAS No. 31, Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec.

326), for guidance when significant auditee information is transmitted, processed, maintained, or accessed electronically.

Prior Audit Findings

7.32 As a part of the risk assessment, the auditor should consider prior audit findings. These findings may be the result of previous single audits by independent auditors or of compliance or financial audits performed by internal auditors or government auditors in conjunction with the federal awarding agency's monitoring activities. The auditor should consider assessing a higher risk for programs for which prior audit findings have a significant impact on a federal program or for which no corrective action has been implemented since the findings were identified.

Federal Programs Not Recently Audited as Major

7.33 Federal programs that have not recently been audited as major programs may be of higher risk than federal programs recently audited as major. For example, many type B programs may never have been audited as major programs in the past. A higher level of risk would likely be assessed on such programs than on those programs that have been consistently audited as major programs without audit findings.

Oversight Exercised by Federal Agencies and Pass-Through Entities

7.34 The oversight exercised by federal agencies or pass-through entities could indicate risk. An important factor in assessing risk is the results of recent audits performed by federal agencies or pass-through entities. For example, recent monitoring or other reviews that were performed by an oversight entity and that disclosed no audit findings may indicate lower risk, whereas monitoring that disclosed significant findings could indicate higher risk. However, the auditor should understand the scope of the review that was performed. Reviews performed by federal agencies or pass-through entities vary widely as to coverage and intensity.

7.35 Circular A-133 states that federal agencies, with the concurrence of the OMB, may identify federal programs that are high-risk. This identification will be provided by the OMB in the *Compliance Supplement*. For example, the U.S. Department of Health and Human Services has identified the Medicaid Assistance Program as a program of higher risk in the *Compliance Supplement*. Although such an identification by a federal agency does not preclude an auditor from determining that a program is low-risk (for example, because prior audits have shown strong internal control and compliance), the auditor should consider it as part of the risk assessment process.

Inherent Risk of the Federal Programs

7.36 As part of the risk assessment, the auditor needs to consider the inherent risk of federal programs. Inherent risk is the risk that material noncompliance with requirements applicable to a major program could occur, assuming there is no related internal control. Programs with higher inherent risk may be of a higher risk for the purpose of determining major programs. Circular A-133 provides examples of program characteristics with potentially higher inherent risks; these are discussed in paragraphs 6.8 and 6.9.

Chapter 8

CONSIDERATION OF INTERNAL CONTROL OVER COMPLIANCE FOR MAJOR PROGRAMS

8.1 Circular A-133 establishes requirements for additional audit procedures and reporting relative to the auditor's consideration of internal control over compliance for major programs. These requirements are beyond those of a financial statement audit conducted in accordance with GAAS and *Government Auditing Standards*. The auditor's consideration of internal control over financial reporting is discussed in chapter 4. In this chapter, the additional considerations of internal control over compliance for major programs are discussed. The reporting on internal control over compliance for major programs is discussed in paragraph 8.3 and chapter 10.

Summary of Circular A-133 Requirements Related to Internal Control Over Compliance for Federal Programs

Auditee Responsibilities

8.2 Circular A-133 requires the auditee to maintain internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs.

Auditor Responsibilities

8.3 In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to—

- Perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs.
- Plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.
- Perform testing of the internal control over compliance as planned.
- Report on internal control over compliance describing the scope of the testing of internal control and the results of the tests and, where applicable, referring to the separate schedule of findings and questioned costs. This schedule includes, where applicable, a statement that reportable conditions in internal control over compliance for major programs were disclosed by the audit and whether any such conditions were material weaknesses.

Auditor Responsibility for Internal Control Over Compliance for Programs That Are Not Major

8.4 The auditor has no responsibility under Circular A-133 to obtain an understanding of internal control over compliance for programs that are not considered major, or to plan or perform any related testing of internal control over compliance for those programs except for any procedures the auditor may choose to perform as part of the risk assessment process in determining major programs (see chapter 7). However, the auditor should note that a program that is not considered major could still be material to the financial statements. In this situation, in conjunction with the financial statement audit, the auditor may need to obtain an understanding of the internal control over financial reporting that is relative to the program. The auditor's consideration of internal control over financial reporting is discussed in chapter 4.

Circular A-133 Definition of Internal Control Over Federal Programs

8.5 Circular A-133 defines internal control over federal programs as follows.

Internal control pertaining to the compliance requirements for federal programs (*Internal control over federal programs*) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for federal programs:

1. Transactions are properly recorded and accounted for to:
 - a. Permit the preparation of reliable financial statements and federal reports;
 - b. Maintain accountability over assets; and
 - c. Demonstrate compliance with laws, regulations, and other compliance requirements;
2. Transactions are executed in compliance with:
 - a. Laws, regulations and the provisions of contracts or grant agreements that could have a direct and material effect on a federal program; and
 - b. Any other laws and regulations that are identified in the compliance supplement; and
3. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Control Objectives

8.6 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, states that there are three categories of internal control: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs of the auditee and others

regarding each separate purpose. For purposes of this SOP, controls relevant to the audit of the financial statements are referred to as “internal control over financial reporting” and are encompassed in the report on internal control over financial reporting that is required by *Government Auditing Standards* (see paragraphs 10.38 through 10.40). Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this SOP “as internal control over compliance” and are encompassed in the report on internal control over compliance required by Circular A-133 (see paragraphs 10.46 through 10.49). See paragraphs 4.11 and 4.12 for a more detailed discussion.

Auditor’s Consideration of Internal Control Over Compliance for Each Major Program

8.7 The auditor’s consideration of internal control over compliance for each major program is similar to the consideration of internal control over financial reporting in a financial statement audit as described in SAS No. 55, as amended by SAS No. 78. In his or her consideration of internal control over compliance, the auditor—

- Obtains an understanding of internal control over compliance for federal programs that is sufficient to plan the audit, by performing procedures to understand (a) the design of controls relevant to the compliance requirements for each major program and (b) whether they have been placed in operation (note that although Circular A-133 requires the auditor to perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs, it does not actually require the achievement of a low assessed level of control risk).
- Assesses control risk for the assertions relevant to the compliance requirements for each major program. The auditor uses the knowledge provided by the understanding of internal control over compliance and the assessed level of control risk to determine the nature, timing, and extent of substantive tests for assertions relevant to the compliance requirements for each major program. Compliance auditing is discussed in chapter 6.

8.8 An understanding of the internal control over compliance and an assessment of control risk may be performed concurrently in an audit. Similarly, based on the assessed level of control risk that the auditor expects to support and on audit efficiency considerations, the auditor often plans to perform some tests of controls concurrently with obtaining an understanding of controls.

Obtaining an Understanding of Internal Control Over Compliance for Major Programs

Understanding Compliance Assertions and Identifying Relevant Controls

8.9 As noted in paragraph 8.3, the auditor is required to perform procedures to obtain an understanding of internal control over compliance for fed-

eral programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs. The determination of major programs is discussed in chapter 7. The auditor needs to understand the assertions relevant to the compliance requirements for each major program. Those assertions will determine the types of controls the auditor needs to consider in a single audit. In identifying controls relevant to specific assertions, the auditor should consider that the controls can have either a pervasive effect on many assertions or a specific effect on an individual assertion depending on the nature of the particular internal control component involved. An entity generally also has controls relating to objectives that are not relevant to specific assertions and that therefore need not be considered in a Circular A-133 audit.

8.10 In obtaining an understanding of controls, the auditor should consider the guidance in paragraphs 41 through 43 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.41–43). This includes performing procedures to provide sufficient knowledge of both the design of the relevant controls pertaining to each of the five internal control components (that is, control environment, risk assessment, control activities, information and communication, and monitoring) and whether they have been placed in operation. The auditor ordinarily obtains this knowledge through previous experience with the entity and through such procedures as inquiries of appropriate management, supervisory, and staff personnel; an inspection of the entity's documents and records; and his or her observation of the entity's activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular control, and the nature of the entity's documentation of specific controls.

8.11 Entities may use the same controls for more than one federal program and for similar transactions (for example, cash disbursements). Accordingly, those controls will often provide assurance regarding the achievement of the compliance objectives related to some or all federal program transactions and assets.

OMB Compliance Supplement *Internal Control Guidance*

8.12 When determining the assertions relevant to the compliance requirements for each major program of the entity, the auditor should consider referring to the discussion on internal control found in part 6 of the *Compliance Supplement*. The *Compliance Supplement* provides a general discussion of the control objectives, components, and activities that are likely to apply to the fourteen types of compliance requirements (see the discussion of the types of compliance requirements in paragraph 6.22). This guidance is not a checklist of required internal control characteristics; it is intended, instead, to assist the auditor in planning and performing the single audit. However, the auditee is responsible for designing and implementing internal control that is sufficient to provide reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. Control activities beyond those discussed in the *Compliance Supplement* may need to be designed and implemented by the auditee to meet this responsibility. Similarly, the auditor is responsible for evaluating internal control over compliance, to plan the audit to support a low assessed level of control risk for each major program. The auditor may need to perform tests of internal control

over compliance that are related to control objectives and activities in addition to those discussed in the *Compliance Supplement*.

Multiple-Component Considerations

8.13 Federal programs are often administered by several organizational components within an auditee. Each component may maintain separate internal control over compliance that is relevant to the programs, or parts of the programs, that the component administers. In these situations, the auditor should perform procedures to obtain an understanding of the internal control over compliance that is separately maintained by organizational components and that is relevant to each material part of a major program, and should plan and perform testing of those controls as discussed in this chapter (see also paragraphs 6.34 and 7.29 for other multiple-component considerations).

Subrecipient Considerations

8.14 Many entities that are pass-through entities for federal awards make subcontract or subgrant awards and disburse their own funds, as well as federal funds, to subrecipients. The auditor of the pass-through entity has certain considerations related to the entity's internal control over the monitoring of subrecipients. See paragraph 9.23 for a discussion of the audit considerations of federal pass-through awards.

Planning and Performing Testing of Internal Control Over Compliance for Major Programs

Assessing Control Risk

8.15 After obtaining an understanding of internal control over compliance for major programs, the auditor makes a preliminary assessment of control risk for the assertions relevant to the compliance requirements for each major program (see also the related discussion in paragraphs 6.7 through 6.12). Control risk is the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the auditee's internal control over compliance. The assessment of control risk is the process of evaluating the effectiveness of an entity's internal control over compliance in preventing or detecting material noncompliance with the compliance requirements for each major program. In assessing control risk, the auditor should consider the guidance in paragraphs 45 through 57 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU secs. 319.45–.57). The auditor should consider the preliminary assessment of control risk when he or she designs the nature and extent of tests of compliance. The Circular A-133 requirement to plan the testing of internal control over compliance to support a low assessed level of control risk is discussed in paragraphs 8.16 through 8.19. The auditor's responsibilities when the internal control over compliance is ineffective in preventing or detecting noncompliance are discussed in paragraphs 8.20 through 8.22.

Planning the Testing of Internal Control Over Compliance for Major Programs to Support a Low Assessed Level of Control Risk

8.16 Circular A-133 requires the auditor to plan the testing of internal control over compliance for major programs to support a low assessed level of

control risk for the assertions relevant to the compliance requirements for each major program. Professional standards do not define or quantify a low assessed level of control risk. A low assessed level of control risk can only be understood in relative terms when it is compared with maximum or moderate levels. Therefore, the auditor exercises professional judgment to determine the procedures necessary to obtain a low level of control risk. The auditor should consider the purpose of the requirement to plan the tests of controls to achieve a low assessed level of control risk (that is, federal agencies want to know if conditions indicate that auditees have not implemented adequate internal control over compliance for federal programs to ensure compliance with applicable laws and regulations).

8.17 Assessing control risk at below the maximum level involves (a) identifying specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions and (b) performing tests of controls to evaluate the effectiveness of such controls.

8.18 When the auditor assesses control risk at below the maximum level, the auditor should obtain sufficient evidential matter to support that assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusions to which it leads all bear on the degree of assurance the evidential matter provides. In obtaining evidential matter, the auditor should consider the guidance in paragraphs 64 through 78 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU secs. 319.64–78).

8.19 Paragraph 4.32 of *Government Auditing Standards* provides the following additional guidance related to the assessment of control risk:

- The lower the auditors' assessment of control risk, the more evidence they need to support that assessment.
- Auditors may have to use a combination of different kinds of tests of controls to get sufficient evidence of a control's effectiveness.
- Inquiries alone generally will not support an assessment that control risk is below the maximum.
- Observations provide evidence about a control's effectiveness only at the time observed; they do not provide evidence about its effectiveness during the rest of the period under audit.
- Auditors can use evidence from tests of controls done in prior audits (or at an interim date), but they have to obtain evidence about the nature and extent of significant changes in policies, procedures, and personnel since they last performed those tests.

Existence of Ineffective Internal Control in Preventing or Detecting Noncompliance

8.20 When internal control over compliance for some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, the auditor is not required to plan and perform tests of internal control over compliance as described in paragraphs 8.3, 8.16, and 8.23. If the internal control over compliance is deemed likely to be ineffective, Circular A-133 requires the auditor to assess control risk at the maximum and consider whether any additional compliance tests are required because of ineffective internal control. The auditor is also required to report a reportable condition (including whether such condition is a material weakness) as part of

the audit findings (see paragraphs 10.46, 10.56, and 10.63 for a discussion of how reportable conditions should be reported).

8.21 The assessment of the effectiveness of internal control over compliance in preventing or detecting noncompliance is determined in relation to each individual type of compliance requirement for each major program or to an audit objective identified in the *Compliance Supplement*. For example, controls over requirements for eligibility may be ineffective because of a lack of segregation of duties. In this case, the auditor would be required to—

- Report the lack of segregation of incompatible duties as it relates to eligibility as a reportable condition (note that the reportable condition could be a material weakness).
- Assess the control risk related to requirements for eligibility at the maximum.
- Consider the lack of effective control when designing the nature, timing, and extent of procedures designed to test compliance with requirements for eligibility of the major program. In most cases, the extent of testing would need to be expanded.

8.22 In planning the tests of controls, the auditor will need to consider the results of tests performed in prior years. If the results of the prior year tests of controls prevented a low level of control risk assessment, the auditor may consider expanded testing in the next audit period. That consideration should include the testing of any changes in internal control over compliance that were intended to eliminate deficiencies noted in the previous year. If, however, the auditee has made no changes to its internal control over compliance, the auditor may determine that controls are not likely to be effective and may choose not to plan and perform tests of controls. In this situation, a reportable condition should be reported (see paragraph 8.20).

Performing Tests to Evaluate the Effectiveness of Controls

8.23 As noted in paragraph 8.3, Circular A-133 requires the auditor to perform testing of internal control over compliance as planned (see paragraphs 8.20 through 8.22 for an exception related to ineffective internal control over compliance). Tests of controls should include the types of procedures described in paragraphs 34 and 35 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.52 and 319.53). Tests of controls, which are directed toward either the effectiveness of the design or the operation of a control, may include such steps as (a) inquiries of appropriate personnel, including grant and contract managers; (b) the inspection of documents and reports; (c) the observation of the application of the specific controls; and (d) the reperformance of the application of the controls by the auditor. The auditor should perform such procedures (unless control is likely to be ineffective) regardless of whether he or she would otherwise choose to obtain evidence to support an assessment of control risk below the maximum level.

Evaluating the Results of Tests of Controls

8.24 If, when evaluating the results of tests of controls, the auditor is not able to support a low assessed level of control risk for major programs, the auditor is not required to expand his or her testing of internal control over compliance. The auditor may choose not to perform further tests. In this situation, the auditor would assess control risk at other than low, design tests

of compliance accordingly, and consider the need to report an audit finding (see paragraph 10.63). In general, a reportable condition or a material weakness will need to be reported. Similarly, the auditor may decide to expand the testing of internal control over compliance, but that decision would be based on whether the auditor considered expanded internal control testing to be more efficient than additional tests of compliance. The auditor should consider whether, based on the testing performed, control risk can be assessed at below the maximum to reduce substantive tests of compliance. If it cannot, the auditor should assess control risk at the maximum level.

Reportable Conditions and Material Weaknesses Related to Federal Programs

8.25 For purposes of reporting on internal control over compliance for federal programs, the definitions of a reportable condition and a material weakness, which are similar to those in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, are as follows:

- A *reportable condition* is a matter coming to the auditor's attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in the auditor's judgment, could adversely affect an entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants.
- A *material weakness* in internal control over compliance is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

8.26 In performing a single audit, the auditor should be aware that reportable conditions and material weaknesses are to be considered as they relate to a type of compliance requirement for each major program or to an audit objective identified in the *Compliance Supplement*. Furthermore, certain conditions may be reportable conditions for a major program and not be considered reportable conditions as they relate to the assertions of management in the financial statements.

Documentation Requirements

8.27 The auditor should document his or her understanding of the auditee's internal control components that was obtained to plan the audit, and should document the basis for his or her conclusions about the assessed level of control risk related to the internal control over compliance for major programs. If the auditor has not performed tests of controls relevant to certain requirements or programs, as discussed in paragraphs 8.20 through 8.22, then the rationale for omitting such tests should be documented.

8.28 As noted in paragraphs 3.16 through 3.18, *Government Auditing Standards* includes an additional standard that requires working papers to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments.

8.29 The form and extent of this documentation is influenced by the size and complexity of the auditee, as well as the nature of the auditee's internal control over compliance. For example, the documentation of the understanding of internal control over compliance of a large, complex entity may include flowcharts, questionnaires, or decision tables. For a small entity, however, the documentation may be less extensive. In general, the more complex the internal control over compliance and the more extensive the procedures performed, the more extensive the auditor's documentation.

Program Cluster Considerations

8.30 An entity may have separate controls related to individual federal programs that are treated as one program "cluster" under a Circular A-133 audit (for example, SFA and R&D—see paragraphs 1.18, 1.19, 2.18, 5.6, and 7.4 for a discussion of program clusters). In this case, when evaluating whether an identified deficiency is a reportable condition, the auditor should consider the significance of the deficiency in relation to the overall major program (program cluster). Following are some examples:

- Significant deficiencies in specific controls over the time cards of college work-study students would likely be considered a reportable condition when college work-study program expenditures are significant in relation to SFA programs.
- Significant deficiencies in controls over a single campus or department of a university where a significant amount of research was administered would likely be a reportable condition when considered in relation to the total expenditures of R&D programs.
- A deficiency in an SFA or R&D program that was clearly insignificant to SFA or R&D, respectively, as a whole would not necessarily be considered a reportable condition.

Chapter 9

AUDIT CONSIDERATIONS OF FEDERAL PASS-THROUGH AWARDS

Introduction

9.1 Many nonfederal entities receiving federal awards make pass-through payments of federal awards to other entities that are considered subrecipients. The amount of those payments may be material to the pass-through entity's financial statements, individual major programs, or both. The auditor's consideration of pass-through federal awards in an audit of both pass-through entities and subrecipients of federal awards under Circular A-133 is discussed in this chapter. The auditee's and auditor's responsibilities with respect to activities carried out by vendors is also discussed in this chapter. An auditee with multiple federal funding agreements may be a pass-through entity in regard to some awards, a subrecipient in regard to other awards, and a vendor with respect to other agreements.

Definitions

9.2 Circular A-133 includes the following definitions that are relevant to pass-through awards:

- *Federal award*—federal financial assistance and federal cost-reimbursement contracts that nonfederal entities receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors.
- *Nonfederal entity*—a state, local government, or non-profit organization (NPO).
- *Recipient*—a nonfederal entity that expends federal awards received directly from a federal awarding agency to carry out a federal program.
- *Pass-through entity*—a nonfederal entity that provides a federal award to a subrecipient to carry out a federal program.
- *Subrecipient*—a nonfederal entity that expends federal awards received from a pass-through entity to carry out a federal program but does not include an individual who is a beneficiary of such a program. A subrecipient may also be a recipient of other federal awards directly from a federal awarding agency.
- *Vendor*—a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the federal program.

Applicability of Circular A-133

9.3 Circular A-133 applies to both recipients expending federal awards received directly from federal awarding agencies and subrecipients expending

federal awards received from a pass-through entity. Accordingly, both recipients and subrecipients that expend \$300,000 or more in federal awards are required to have a single or program-specific audit in accordance with Circular A-133 (see chapter 11 for a detailed discussion of program-specific audits).

9.4 The determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards passed through to subrecipients, the activity that requires the pass-through entity to comply with laws, regulations, and the provisions of contracts or grant agreements is the disbursement of funds to subrecipients. The activity that requires subrecipients to comply with laws, regulations, and the provisions of contracts or grant agreements is the expenditure of the pass-through award.

9.5 Payments received by a vendor for goods or services provided in connection with a federal program are not considered federal awards. Furthermore, Medicaid payments to a subrecipient for providing patient care services to Medicaid-eligible individuals are not considered federal awards expended under Circular A-133 unless a state requires the funds to be treated as federal awards expended because reimbursement is on a cost-reimbursement basis.

9.6 If a pass-through entity provides federal awards to subrecipients, the pass-through entity must monitor the subrecipients' activities to provide reasonable assurance that the subrecipients administer federal awards in compliance with federal requirements. As part of the compliance audit, the auditor of the pass-through entity must test and report on subrecipient monitoring (which is one of the fourteen types of compliance requirements in the *Compliance Supplement*—see paragraph 6.22) when federal awards passed through to subrecipients are material to a major program (see paragraphs 9.24 through 9.35). If the federal awards provided are immaterial or relate to a program that is not considered major, the auditor of the pass-through entity has no additional compliance auditing responsibilities related to the funds passed through to subrecipients.

9.7 Most of this chapter focuses on compliance auditing considerations for auditors of pass-through entities. However, paragraphs 9.43 through 9.47 provide additional considerations for auditors of subrecipients.

Pass-Through Entities, Subrecipients, and Vendors

Subrecipient Status Versus Vendor Status

9.8 The responsibilities for compliance with federal program requirements and the applicable compliance requirements to be tested by the auditor are significantly different for pass-through entities, subrecipients, and vendors. Guidance on distinguishing between a subrecipient and a vendor is provided in section 210 of Circular A-133 and is summarized in paragraphs 9.9 through 9.11.

Characteristics Indicative of a Federal Award Received by a Subrecipient

9.9 According to Circular A-133, characteristics indicative of a federal award received by a subrecipient are when the entity (see paragraph 9.12 for examples of the relationship between pass-through entities and subrecipients)—

- Determines who is eligible to receive what federal financial assistance.
- Has its performance measured against whether the objectives of the federal program are met.

- Has responsibility for programmatic decision making.
- Has responsibility for adherence to applicable federal program compliance requirements.
- Uses the federal funds to carry out a program of the entity as compared to providing goods or services for a program of the pass-through entity.

Characteristics Indicative of a Payment for Goods or Services Received by a Vendor

9.10 According to Circular A-133, the characteristics indicative of a payment for goods or services received by a vendor are when the entity (see paragraph 9.13 for examples of the relationship between recipients and vendors)—

- Provides the goods and services within normal business operations.
- Provides similar goods or services to many different purchasers.
- Operates in a competitive environment.
- Provides goods or services that are ancillary to the operation of the federal program.
- Is not subject to the compliance requirements of the federal program.

Use of Judgment in Determining Subrecipient or Vendor Status

9.11 Circular A-133 states that there may be unusual circumstances or exceptions to the listed characteristics in paragraphs 9.9 and 9.10. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present, and judgment should be used in determining whether an entity is a subrecipient or vendor. In some cases, it may be difficult to determine whether the relationship with the entity is that of a subrecipient or of a vendor. The federal cognizant agency for audit, the oversight agency for audit, or the federal awarding agency may be of assistance in making these determinations.

Description of Relationships

Pass-Through Entity and Subrecipient

9.12 Following are examples of a typical relationship between a pass-through entity and a subrecipient:

- A state department of education (pass-through entity) receives a federal award and is responsible for administering and disbursing the federal award to local school districts (subrecipients) according to a formula or some other basis.
- A regional planning commission (pass-through entity) receives a federal award for the feeding of elderly and low-income individuals, and the award is disbursed to NPOs (subrecipients) to support their feeding programs.
- A hospital (subrecipient) receives a federal award from a university (pass-through entity) to conduct research.
- A theater group (subrecipient) receives a federal award from a state arts commission (pass-through entity) to support a summer arts series.

Recipient and Vendor

9.13 Following are examples of a typical relationship between a recipient and a vendor:

- A local government (recipient) receives a federal award to provide mental health services in a designated area. Some of the funds are paid to a contractor (vendor) to repair a leaking roof.
- A county (recipient) receives a federal award to operate a Head Start program and pays a NPO (vendor) to provide temporary clerical services.
- An NPO (recipient) receives a federal award to run a preschool and pays a medical doctor (vendor) to perform health screening on a per-student basis.
- An NPO (recipient) receives a federal award to operate a child care center and pays a not-for-profit clinic (vendor) to perform physical exams.

Entity is Both a Subrecipient and a Pass-Through Entity

9.14 There are instances in which an entity can be both a subrecipient and a pass-through entity as shown in the following examples:

- A local government receives a pass-through federal award from a state government agency (the local government is a subrecipient) and further passes through a portion of the federal award to an NPO (the local government is also a pass-through entity) to administer a federal program.
- A not-for-profit area agency receives a pass-through federal award from a state (the not-for-profit area agency is a subrecipient) and further passes through a portion of the federal award to a for-profit health care provider (the not-for-profit area agency is also a pass-through entity). See paragraph 9.40 for a discussion of a pass-through entity's responsibilities when the subrecipient is a for-profit entity.

Vendor Compliance Considerations*Auditee's Responsibilities*

9.15 Circular A-133 states that in most cases, the auditee's compliance responsibility for a vendor is only to ensure that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. A program's compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions that are structured such that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine compliance.

Auditor's Responsibilities

9.16 When vendors are responsible for program compliance, the auditor should determine whether vendor transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements if such transactions are material to a major program of the auditee. In such a case, the auditor would normally evaluate a vendor's compliance by reviewing the auditee's records and the results of the auditee's procedures for ensuring com-

pliance by the vendor. When the auditor cannot obtain sufficient assurance from reviewing the auditee's records and procedures, the auditor should consider the need to report a reportable condition. The auditor will also ordinarily need to perform additional procedures to determine compliance. These procedures may include testing the vendor's records or obtaining reports on compliance procedures performed by the vendor's independent auditor.

9.17 Prior to performing a single or program-specific audit, it is important for the auditor to understand the nature of the auditee's vendor relationships, whether the vendors are responsible for program compliance, the auditee's procedures for ensuring vendor compliance, and whether it will be necessary for the auditor to test vendor records. The auditor should consider including such information in the communication used to establish an understanding with the auditee (see paragraphs 3.6 and 3.7). If subsequent to undertaking a single or program-specific audit the auditor becomes aware of a significant vendor relationship that will require the auditor to perform additional procedures on vendor records, the auditor should inform the auditee that the requirements of Circular A-133 will not be met unless additional procedures are performed. If the auditee or vendor precludes the auditor from performing such additional procedures, the auditor should qualify his or her opinion or disclaim an opinion because of a scope limitation (see paragraphs 10.43 through 10.45 for a further discussion of scope limitations).

Single Audit Considerations of Pass-Through Entities

9.18 The following matters are relevant to planning and conducting a single audit of a pass-through entity:

- Pass-through entity responsibilities (see paragraph 9.19)
- Audit planning considerations (see paragraphs 9.20 through 9.22)
- Consideration of internal control over compliance (see paragraph 9.23)
- Subrecipient monitoring (see paragraphs 9.24 through 9.35)
- Reporting considerations (see paragraphs 9.36 through 9.39)
- For-profit subrecipients (see paragraph 9.40)
- Non-U.S.-based entities (see paragraph 9.41)
- A state's designation of a cluster of programs (see paragraph 9.42)

Pass-Through Entity Responsibilities

9.19 A pass-through entity is responsible for ensuring that subrecipients expend awards in accordance with applicable laws, regulations, and provisions of contracts or grants. Circular A-133 requires a pass-through entity to perform the following for the federal awards it provides to subrecipients:

- Identify the federal awards made by informing each subrecipient of the CFDA title and number, the award's name and number, the award year, whether the award is for R&D, and the name of the federal agency. When some of this information is not available, the pass-through entity should provide the best information available to describe the federal award.
- Advise subrecipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements, as well as any supplemental requirements imposed by the pass-through entity.

- Monitor the activities of subrecipients as necessary to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- Ensure that subrecipients expending \$300,000 or more in federal awards during the subrecipient's fiscal year have met the audit requirements of Circular A-133 for that fiscal year.
- Issue management decisions on audit findings within six months after receipt of subrecipients' audit reports, and ensure that subrecipients take appropriate and timely corrective action.
- Consider whether subrecipient audits necessitate the adjustment of the pass-through entity's own records.
- Require subrecipients to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with Circular A-133.
- Keep subrecipients' report submissions (or other written notification when the subrecipient is not required to submit a reporting package) on the file for three years from the date of receipt (see paragraphs 9.47, 10.76, and 10.78).

Audit Planning Considerations

Impact of Pass-Through Federal Awards on the Determination of Major Programs

9.20 As noted in paragraph 9.4, the determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards provided by a pass-through entity to subrecipients, the federal awards are deemed to be expended by the pass-through entity when the funds are disbursed to subrecipients, regardless of when subrecipients expend the federal funds. Accordingly, the amount of federal funds disbursed to subrecipients should be included in the total expenditures of federal awards of the pass-through entity and in the determination of the pass-through entity's major programs (see chapter 7 for a more detailed discussion of the determination of major programs).

Pass-Through Entity Request for a Program to Be Audited as a Major Program

9.21 When a subrecipient expends \$300,000 or more of federal awards, Circular A-133 permits the pass-through entity to request that the program be audited as a major program in lieu of the pass-through entity conducting or arranging for additional audits. If the pass-through entity makes such a request, it is required to pay the full incremental cost for such an audit (see paragraph 2.19 for additional information).

Materiality

9.22 The auditor of the pass-through entity should compare the amount of federal funds passed through to subrecipients with the total expenditures for each individual major program or cluster to determine if the amount is material. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person who will rely upon the auditor's work. When the amount of

federal funds passed through to subrecipients is material in relation to the major program being audited, the greater the need for the auditor to test the subrecipient-monitoring requirements. It should be noted that some federal programs are designed in such a manner that subrecipient expenditures are intended to be material to the pass-through entity's award. For example, the Community Services Block Grant requires a state to subgrant at least 90 percent of the state's award.

Consideration of Internal Control Over Compliance

9.23 As part of performing procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit of the pass-through entity to support a low assessed level of control risk for major programs, the auditor should consider the pass-through entity's internal control over compliance used to monitor subrecipients (see chapter 8 for an additional discussion of considerations concerning internal control over compliance). Tests of internal control over compliance used to monitor subrecipients may include inquiry, observation and inspection of documentation, or a reperformance by the auditor of some or all of the monitoring procedures identified in paragraph 9.28. The nature and extent of the tests performed will vary depending on the auditor's assessment of inherent risk, understanding of the internal control over compliance, materiality, and professional judgment. Auditors should consider referring to part 6 of the *Compliance Supplement*, which describes (among other things) certain characteristics of internal control over compliance that, when present and operating effectively, may ensure compliance with program requirements for subrecipient monitoring. The results of the auditor's testing of internal control over compliance assist in determining the nature, timing, and extent of subrecipient monitoring compliance testing.

Subrecipient Monitoring

9.24 The Single Audit Act requires the pass-through entity to monitor subrecipients' use of federal awards through site visits, limited scope audits, or other means. Since the pass-through entity is held accountable for federal awards administered by their subrecipients, the pass-through entity needs to establish an appropriate subrecipient-monitoring process and to decide what, if any, additional monitoring procedures may be necessary to ensure the subrecipients' compliance. Arrangements for subrecipient monitoring should be made by the pass-through entity in its agreements with subrecipients.

9.25 Auditors must consider subrecipient monitoring in a compliance audit of an entity that disburses to subrecipients federal awards that are material to a major program (see the discussion of materiality in paragraph 9.22). The auditor should consider whether the pass-through entity monitors subrecipients and has established internal control over compliance that provides reasonable assurance that subrecipients are managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of the pass-through entity's major programs.

Compliance Supplement Guidance

9.26 One of the fourteen types of compliance requirements included in the *Compliance Supplement* is subrecipient monitoring. The *Compliance Supplement* identifies several audit objectives for subrecipient monitoring. According

to the *Compliance Supplement*, in a single audit of a pass-through entity, the auditor should determine whether the pass-through entity—

- Identified the federal award's information and compliance requirements to the subrecipient.
- Monitored the subrecipient's activities to provide reasonable assurance that the subrecipient administered federal awards in compliance with federal requirements.
- Ensured that the required audits were performed, and required appropriate corrective action concerning monitoring and audit findings.
- Evaluated the impact of subrecipient activities on the pass-through entity.

9.27 The *Compliance Supplement* also identifies the suggested audit procedures for testing the compliance audit objectives for pass-through entities (see paragraph 6.44 for a further discussion of suggested audit procedures). The auditor may consider coordinating the subrecipient-related tests performed as part of activities allowed or unallowed (tests that subrecipient agreements were for allowable activities), cash management (tests of cash reports submitted by subrecipients), eligibility (tests that subawards were made only to eligible subrecipients), and procurement (tests of suspension and debarment certifications) with the tests of subrecipient monitoring.

Pass-Through Entity Monitoring Procedures

9.28 The monitoring procedures used by the pass-through entity may include on-site visits, reviews of documentation supporting requests for reimbursement, and limited-scope audits. Section 230(b)(2) of Circular A-133 defines limited-scope audits as agreed-upon procedures engagements that are conducted in accordance with either GAAS or the AICPA attestation standards, and that are paid for and arranged by a pass-through entity and only address one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching, level of effort, earmarking; and reporting. Following are other monitoring procedures that a pass-through entity may perform:

- Reviewing grant applications submitted by subrecipients to determine that—
 - Applications are filed and approved in a timely manner
 - Each application contains the condition that the subrecipient comply with the federal requirements set by the federal agency
- Establishing internal control over compliance to provide reasonable assurance that—
 - Funds are disbursed to subrecipients only on an as-needed basis
 - Funds are disbursed to subrecipients only on the basis of approved, properly completed reports submitted on a timely basis
 - Refunds that are due from subrecipients are billed and collected in a timely manner
 - Subrecipients and other entities and individuals receiving federal funds meet eligibility requirements
- Reviewing financial and technical reports received from subrecipients on a timely basis and investigating unusual items

- Reviewing subrecipient audit reports, to evaluate them for completeness and for compliance with applicable laws and regulations
- Evaluating audit findings; issuing appropriate management decisions, if necessary; and determining if an acceptable plan for corrective action has been prepared and implemented
- Reviewing previously detected deficiencies and determining that corrective action was taken

Monitoring When the Subrecipient Has a Single or Program-Specific Audit

9.29 As noted in paragraph 9.3, subrecipients that expend \$300,000 or more in federal awards are required to have a single or program-specific audit in accordance with Circular A-133. If subrecipients have a single or program-specific audit, the pass-through entity's receipt and review of the results of that audit and its action on related findings may be sufficient to meet the subrecipient-monitoring requirements of Circular A-133. However, it is more likely that the receipt and review of such audit results should be merely one tool that should be used by the pass-through entity as part of a comprehensive subrecipient-monitoring process. Pass-through entities should be aware that a single audit is likely to provide varying degrees of assurance concerning a particular program. For example, a pass-through award may not have been tested as a major program as part of a subrecipient's audit. For this reason, the pass-through entity should consider the testing and results of the single audit of the subrecipient to determine what effect those results should have on other monitoring procedures employed by the pass-through entity.

9.30 In many cases, the pass-through entity will not have received all the subrecipient audit reports covering the time period being audited at the pass-through entity in time to incorporate the results into its own audit. The reports for the pass-through entity and the subrecipient are not required to be issued simultaneously, but the pass-through entity is required to have internal control over compliance in place, to determine that subrecipient audit reports have been received and that corrective action is taken after the receipt of the subrecipient's audit. If the subrecipient's audit report is current, it need not cover the same period as the pass-through entity's audit. If the pass-through entity has an effective system for monitoring subrecipients, its auditor should be able to rely on the subrecipient's audit cycle, even if it is not coterminous with the pass-through recipient's fiscal year.

Considering Risk Factors When Developing Monitoring Procedures

9.31 The preamble to Circular A-133 states that the OMB expects pass-through entities to consider various risk factors (such as the relative size and complexity of the federal awards administered by subrecipients, the entity's prior experience with each subrecipient, and the cost-effectiveness of various monitoring procedures) in developing subrecipient-monitoring procedures. For example, if a pass-through entity provides a large percentage of the only federal award it expends to ten subrecipients that each expend less than \$300,000 in federal awards annually, the pass-through entity should carefully consider the most cost-effective method of monitoring these federal awards. Perhaps the majority of this federal award is provided to two subrecipients. The pass-through entity might consider conducting site visits at these two subrecipients and simply reviewing the documentation supporting requests for reimbursement from the other eight subrecipients. Conversely, if a small per-

centage of a federal award is provided to subrecipients that each expend less than \$300,000 in federal awards, the risk to the pass-through entity is most likely low and, therefore, the monitoring procedures could be minimal.

Unallowable Audit Costs

9.32 For subrecipients that expend less than \$300,000 in federal awards annually, the cost of any audits or attestation engagements (other than the limited-scope audits paid for and arranged by a pass-through entity as described in paragraph 9.28), are not allowable costs and, therefore, cannot be charged to any federal award. Accordingly, Circular A-133 would prohibit the cost of a financial statement audit conducted in accordance with GAAS or *Government Auditing Standards* from being charged (by either a pass-through entity or subrecipient) to federal awards for a subrecipient that expends less than \$300,000 in federal awards annually. The allowability of audit costs is discussed in greater detail in paragraph 2.12.

When the Subrecipient Monitoring System Is Not Sufficient

9.33 The auditor may determine that the pass-through entity's subrecipient-monitoring system is not sufficient to ensure subrecipient's compliance with laws, regulations, and the provisions of grants and contracts. In this situation, the auditor should report a reportable condition (and possibly a material weakness) and consider whether the insufficient monitoring system represents an instance of noncompliance that should be reported as a compliance finding. The effect of the noncompliance on the opinion on compliance for major programs is primarily a function of the pervasiveness of the lack of monitoring and the materiality of subrecipient funding to a program. For example, if the pass-through entity did not perform subrecipient-monitoring procedures and 90 percent of the program was passed through to subrecipients, an opinion modification would likely be warranted. This would likely be the case even if the scope of the audit was expanded to include additional audit procedures to determine that the subrecipients actually complied with laws and regulations.

9.34 There may be instances in which the pass-through entity asks the auditor to perform additional procedures to determine the compliance of a subrecipient (such as conducting tests of records at the subrecipient's site). This would be considered an expansion of the scope of the audit. The auditor should be aware that such an expansion of the scope of the audit would not be sufficient to remedy the reportable condition (or material weakness) and, if applicable, noncompliance of the pass-through entity's monitoring system. However, an expansion of the scope of the audit may remedy the noncompliance related to the type of compliance requirement being tested (for example, eligibility).

9.35 The auditor should also consider any implications of an insufficient subrecipient-monitoring system on the opinion on the financial statements. If amounts passed through to subrecipients are considered material to the financial statements of the pass-through entity, the auditor should determine whether the report on the financial statements should be modified. Before making this determination, the auditor should take into consideration any evidential matter that may be available to the auditor (such as subrecipients' Circular A-133 audit reports and other financial reports that may have been submitted to the pass-through entity) that could indicate that the subrecipients administered the program in compliance with laws and regulations. Fur-

ther, the auditor should also consider whether it is necessary to report an internal control or compliance finding in the report issued to meet the requirements of *Government Auditing Standards*.

Reporting Considerations

Schedule of Expenditures of Federal Awards

9.36 Circular A-133 states that, to the extent practical, pass-through entities should identify in the schedule of expenditures of federal awards the total amount provided to subrecipients from each federal program (see chapter 5 for an additional discussion of the schedule). If a pass-through entity is unable to identify amounts provided to subrecipients, the auditor should consider whether a reportable condition (and possibly a material weakness) should be reported. The auditor should also consider whether material non-compliance (for subrecipient monitoring) that is required to be reported as an audit finding has occurred.

Evaluation of Audit Findings

9.37 Circular A-133 requires the auditor to consider a finding in relation to the type of compliance requirement (subrecipient monitoring, in this case) or an audit objective identified in the *Compliance Supplement*, whether or not the finding can be quantified. For example, the auditor may discover that a pass-through entity consistently failed to provide its subrecipients with federal award information, including applicable compliance requirements. The pertinent audit objective included in the *Compliance Supplement* and relating to this example is for the auditor to “determine whether the pass-through entity identifies federal award information and compliance requirements to the subrecipient.” Because the pass-through entity failed to provide federal award information to its subrecipients, this noncompliance is material in relation to the audit objective and, therefore, must be reported as an audit finding. In addition, the auditor must consider whether reportable conditions (and possibly, material weaknesses in internal control) exist and require reporting with respect to subrecipient monitoring.

Effect of Subrecipients’ Noncompliance on the Pass-Through Entity’s Report

9.38 The instances of noncompliance reported in subrecipients’ audit reports are not required to be included in the pass-through entity’s audit report. However, the auditor of the pass-through entity should consider the effects of reported instances of subrecipient noncompliance or indications of weaknesses in the pass-through entity’s subrecipient-monitoring system that could have a material effect on each of the pass-through entity’s major programs.

Adjustment of Pass-Through Entity Financial Records and Reports

9.39 Questioned costs at the subrecipient level that are found to be unallowable by the pass-through entity may require the pass-through entity to adjust its financial records and its federal expenditure reports. The total of allowable program costs in excess of required expenditure levels and the requirements of individual programs regarding the timing of claims will affect whether the pass-through entity will need to reflect a liability to the awarding agency in its financial statements. As part of the finding-resolution process, the

pass-through entity should estimate the total unallowable costs that are associated with each subrecipient finding and consider the need to adjust financial records and federal expenditure reports. The failure of the pass-through entity to adjust its records and federal reports should be considered by the auditor in forming an opinion on compliance for major programs.

For-Profit Subrecipients

9.40 Since Circular A-133 does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. Circular A-133 states that the contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits. The auditor's responsibilities related to for-profit subrecipients are similar to those of not-for-profit subrecipients, see paragraphs 9.24 through 9.35 (as applicable) for a further discussion of subrecipient monitoring.

Non-U.S.-Based Entities

9.41 Circular A-133 does not apply to non-U.S.-based entities expending federal awards received either directly as a recipient or indirectly as a subrecipient (see paragraph 2.6 for a further discussion of non-U.S.-based entities). Therefore, the responsibilities that a pass-through entity and its auditor have for a non-U.S.-based entity are the same as those for a for-profit subrecipient (see paragraph 9.40).

State Designation of a Cluster of Programs

9.42 Circular A-133 includes a provision that allows a state to designate as a cluster a grouping of closely related programs that share common compliance requirements. When designating a cluster of programs, a state is required by Circular A-133 to identify the federal awards included in the cluster and to advise subrecipients of the compliance requirements applicable to the cluster. See paragraphs 1.18, 1.19, 2.18, 5.6, 7.4, and 8.30 for additional discussion of clusters.

Circular A-133 Audit Considerations of Subrecipients

9.43 Auditors of subrecipients should be aware that subrecipients have additional considerations under Circular A-133. These considerations are related to additional compliance requirements established by the pass-through entity, information included in the schedule of expenditures of federal awards, audit findings, and the submission of the report.

Additional Compliance Requirements Established by Pass-Through Entities

9.44 Federal awards are normally distributed to subrecipients only on the basis of properly completed and approved awards. These written agreements require subrecipients to comply with the requirements of the federal agency

and, in some instances, additional requirements established by the pass-through entity. Hence, in addition to providing an audit satisfying the requirements of Circular A-133, the auditor may be engaged to test compliance with requirements specified by the pass-through entity.

Information Included in the Schedule of Expenditures of Federal Awards

9.45 For federal awards received as a subrecipient, the schedule of expenditures of federal awards is required to include the name of the pass-through entity and identifying number assigned by the pass-through entity. Circular A-133 states that to make the schedule easier to use, subrecipients may choose to provide information requested by federal awarding agencies and pass-through entities, although this information is not required. Chapter 5 includes more detailed information about the schedule.

Audit Findings

9.46 Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as a single audit finding. Circular A-133 states that where practical, audit findings should be organized by federal agency or pass-through entity (see chapter 10 for an additional discussion of audit findings).

Submission of Report

9.47 Section 320(e) of Circular A-133 has additional report-submission responsibilities for subrecipients. When a subrecipient is not required to submit a reporting package to the pass-through entity (because it has no audit findings or the summary schedule of prior audit findings does not report the status of any audit findings), the subrecipient is required to provide written notification of this to the pass-through entity. The required contents of the written notification and the submission of the report by subrecipients are discussed in paragraph 10.76.

Chapter 10

AUDITOR REPORTING REQUIREMENTS AND OTHER COMMUNICATION CONSIDERATIONS IN A SINGLE AUDIT

Overview

10.1 In this chapter the auditor's reporting requirements and other communication considerations in a single audit under Circular A-133 are discussed. The auditor's reporting requirements in a program-specific audit are discussed in chapter 11.

10.2 The auditor's reporting responsibilities in a single audit are driven by the three levels of auditing standards and requirements: GAAS, *Government Auditing Standards*, and Circular A-133. These standards and requirements expand the level of auditor responsibility from reporting on an auditee's financial statements to also reporting on internal control and on compliance. The auditor has additional reporting responsibilities for the audit of the financial statements in accordance with *Government Auditing Standards* (see chapter 4), and for the compliance audit applicable to major programs in accordance with Circular A-133 (see chapters 6 through 8). The auditor also has additional communication considerations under GAAS and *Government Auditing Standards* related to matters noted in the single audit.

Circular A-133 Requirements

Auditor's Reports

10.3 Circular A-133 requires the auditor's report(s) to include—

- An opinion (or disclaimer of opinion) on whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP) (see paragraph 10.12 for a discussion of the basis of accounting) and an opinion (or a disclaimer of opinion) on whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.
- A report on the internal control related to the financial statements and on the internal control related to major programs. This report must describe the scope of testing of internal control and the results of the tests and, where applicable, must refer to the separate schedule of findings and questioned costs.
- A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report must also include an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major program, and where applicable, must refer to the separate schedule of findings and questioned costs.

- A schedule of findings and questioned costs (see paragraphs 10.55 through 10.67).

The auditor's reports recommended in this SOP are described in paragraphs 10.8 through 10.10 below.

Data Collection Form

10.4 Circular A-133 also requires the auditor to complete applicable sections and sign a data collection form that summarizes the auditor's results, findings, and questioned costs (see paragraphs 10.71 through 10.73).

Other Communication Considerations

10.5 The auditor has certain additional communication considerations under GAAS and *Government Auditing Standards* related to internal control, noncompliance, fraud, illegal acts, and other matters noted in the single audit (see paragraphs 10.13 through 10.30).

Reporting Package

10.6 The auditee is required to submit a reporting package that includes the following:

- Financial statements and a supplementary schedule of expenditures of federal awards (see chapters 4 and 5);
- Auditor's reports (see paragraphs 10.8 through 10.10);
- A summary schedule of prior audit findings (see paragraphs 10.68 through 10.70);
- A corrective action plan (see paragraphs 10.68 through 10.70).

10.7 Although not part of the reporting package, the report submission to the Federal Audit Clearinghouse (FAC) must also include the data collection form described in paragraphs 10.71 through 10.73. The requirements for report submission are discussed in paragraphs 10.74 through 10.79.

Recommended Auditor's Reports

10.8 Reporting on a financial statement audit and on the compliance requirements applicable to each major program involves varying levels of materiality and different forms of reporting. Circular A-133 states that the auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in the circular. In an effort to make the reports understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued:

- a. An opinion on the financial statements and on the supplementary schedule of expenditures of federal awards (see paragraph 10.35 through 10.37)¹
- b. A report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards* (see paragraphs 10.38 through 10.40)

¹ Note that in certain circumstances the auditor may report on the schedule of expenditures of federal awards in his or her report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133. See paragraph 10.36 for a further discussion.

- c. A report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133 (see paragraphs 10.46 through 10.54)
- d. A schedule of findings and questioned costs (see paragraphs 10.55 through 10.67)

10.9 Example reports are provided in appendix D of this SOP. As noted previously, those reports combine reports on compliance and internal control at the financial statement audit level and at the major program compliance audit level. Auditors need to understand the intended purpose of the reports and should tailor the reporting to the specific auditee situation. Because the reports issued to comply with Circular A-133 involve varying levels of materiality and different forms of reporting, auditors should exercise care in issuing reports to ensure that they meet all of the varying reporting requirements of GAAS, *Government Auditing Standards*, and Circular A-133. The basic elements of each of the recommended reports are discussed later in this chapter. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

10.10 Table 10.1 provides a matrix depicting the recommended auditor’s reports in a single audit required by GAAS, *Government Auditing Standards*, and Circular A-133.

Table 10.1

Recommended Reporting in Single Audits

| Report | Required by— | | |
|---|--------------|-------------------------------|----------------|
| | GAAS | Government Auditing Standards | Circular A-133 |
| Opinion (or disclaimer of opinion) on financial statements and supplementary schedule of expenditures of federal awards | X | X | X |
| Report on compliance and on internal control over financial reporting based on an audit of financial statements | | X | X |
| Report on compliance and internal control over compliance applicable to each major program (this report must include an opinion [or a disclaimer of opinion] on compliance) | | | X |
| Schedule of findings and questioned costs | | | X |

Reporting on the Financial Statements and Supplementary Schedule of Expenditures of Federal Awards in Accordance With GAAS and *Government Auditing Standards*

10.11 In this section the reporting and additional communication requirements under GAAS and *Government Auditing Standards* that are related to a financial statement audit and the supplementary schedule of expenditures of federal awards are discussed.

Basis of Accounting

10.12 Circular A-133 and *Government Auditing Standards* do not prescribe the basis of accounting that must be used by auditees to prepare their financial statements and the schedule of expenditures of federal awards. However, auditees are required to disclose the basis of accounting and the significant accounting policies used in preparing the financial statements and the schedule of expenditures of federal awards. The auditee must also be able to reconcile amounts presented in the financial statements to related amounts included in the schedule of expenditures of federal awards. The auditor is required to report whether the financial statements are presented fairly in all material respects in conformity with GAAP and whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole (see paragraphs 4.3 and 10.13 for a discussion of the auditor's responsibilities when the auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP).

GAAS Requirements

10.13 The applicable reporting requirements are established in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508). For an auditee that prepares its financial statements in conformity with a basis of accounting other than GAAP, auditors should follow the guidance in SAS No. 62, *Special Reports*. In reporting on the supplementary schedule of expenditures of federal awards, auditors should follow the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). Auditors may also refer to the AICPA Audit and Accounting Guides *Not-For-Profit Organizations*, *Audits of State and Local Governmental Units*, *Health Care Organizations*, and *Audits of Colleges and Universities*² for additional guidance on reporting on the financial statements of specific industries. See also paragraphs 10.17 through 10.30 for a discussion of additional reporting and communication requirements.

10.14 SAS No. 61, *Communication With Audit Committees*, requires the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for the oversight of the financial reporting process. Matters to be communicated include (among other things) the auditor's responsibilities, significant accounting policies, management judgments and accounting estimates, significant audit adjustments, disagreements with management, and difficulties encountered in performing the audit. In addition to the SAS No. 61 requirements described above, *Government Auditing Standards* also requires the auditor to communicate certain information to the audit committee. See paragraph 10.16 for a further discussion.

Government Auditing Standards Requirements

10.15 Government Auditing Standards requires that in addition to reporting on the financial statements, the auditor report on (1) compliance with laws, regulations, and provisions of contracts and grant agreements that could

² Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

have a direct and material effect on the financial statements amounts and (2) the scope of testing of the auditee's internal control over financial reporting and on the results of the tests.

10.16 The reporting standards for financial audits in *Government Auditing Standards* contain five additional reporting standards for financial statement audits beyond GAAS (see also paragraphs 3.19 through 3.21):

- a. Auditors should communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit. Such matters include the auditor's responsibility in a financial statement audit, as well as the nature of any additional testing of internal control and compliance required by laws or regulations. To help audit committees and other responsible parties understand the limitations of auditors' responsibilities for testing and reporting on internal control and compliance, auditors should contrast those responsibilities with other financial related audits of controls and compliance. The communication may be oral or in writing. If the information is communicated orally, the auditor is required to document the communication in the working papers (see paragraphs 5.5 through 5.10 of *Government Auditing Standards* and paragraphs 3.19 through 3.20 of this SOP for a further discussion).
- b. When the report on the financial statement is submitted to comply with a requirement for an audit in accordance with *Government Auditing Standards*, audit reports should state that the audit was made in accordance with generally accepted government auditing standards. This SOP recommends the following language be included in the auditor's report to meet this requirement: "we conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States."³ *Government Auditing Standards* also acknowledges that an auditee may need a financial statement audit for purposes other than to comply with a requirement calling for an audit in accordance with *Government Auditing Standards*. For example, the auditee may need a financial statement audit to issue bonds. In this case, *Government Auditing Standards* permits auditors to issue a separate report on the financial statements conforming only to the requirements of GAAS (see paragraphs 5.11 through 5.14 of *Government Auditing Standards*).
- c. The report on the audit of the financial statements should either (1) describe the scope of the auditor's testing of compliance with laws and regulations and internal control and present the results of those tests or (2) refer to separate reports containing that information (see paragraphs 5.15 through 5.28 of *Government Auditing Standards*). The financial statement reporting recommended in this SOP (appendix D, examples 1 and 1a), illustrates the second option to refer to a separate report on compliance with certain provisions of laws, regulations, contracts, and grants and on internal control over financial reporting. In presenting the results of tests, the auditor should report

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

fraud, illegal acts, other material noncompliance, and reportable conditions in internal control (see paragraphs 10.17 through 10.30). In some circumstances, the auditor should report fraud and illegal acts directly to parties external to the audited entity (see paragraphs 10.23 through 10.25).

- d. If certain information is prohibited from general disclosure (that is, prohibited from general disclosure by federal, state, or local laws or regulations), the audit report should state the nature of the information omitted and the requirement that makes the omission necessary (see paragraphs 5.29 through 5.31 of *Government Auditing Standards*).
- e. Written audit reports are to be submitted by the audit organization to the appropriate officials of the auditee and to the appropriate officials of the organizations requiring or arranging for the audit (including external funding organizations), unless legal restrictions prevent it.⁴ Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection (see paragraphs 5.32 through 5.35 of *Government Auditing Standards*).

Fraud, Illegal Acts, and Other Noncompliance

GAAS Requirements

10.17 In SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317.17), the auditor's responsibilities with respect to the consideration of illegal acts,⁵ including communications with the audit committee or others with equivalent authority or responsibility are discussed.⁶ Paragraph 17 of SAS No. 54, requires the auditor to assure himself or herself that the audit committee or others with equivalent authority and responsibility are adequately informed with respect to illegal acts that come to the auditor's attention. The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated. The communication should describe the act, the circumstances of its occurrence, and its effect on the financial statements. If senior management is involved, the auditor should communicate directly with the audit committee. The communication may be oral or written. If the communication is oral, the auditor should document it. Paragraphs 4.24 through 4.31 summarize the other requirements of SAS No. 54. The auditor should also consider the effect of any noncompliance on the financial statements, and should modify the auditor's report on those financial statements as necessary in accordance with SAS No. 58.

10.18 The auditor's responsibilities for communications about fraud to management, the audit committee, and others based on a financial statement

⁴ Note that when public accountants are engaged, the engaging organization should ensure that the report is distributed appropriately.

⁵ SAS No. 54 defines the term *illegal acts* as violations of laws or government regulations.

⁶ For auditees that do not have audit committees, the phrase "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities.

audit in accordance with GAAS are discussed in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the auditee's organization. Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported directly to the audit committee. The disclosure of possible fraud to parties other than the auditee's senior management and its audit committee is ordinarily not part of the auditor's responsibility and would ordinarily be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose outside the auditee may exist:

- To comply with certain legal and regulatory requirements
- To a successor auditor when the successor makes inquiries in accordance with SAS No. 84, *Communications Between Predecessor and Successor Auditors*
- In response to a subpoena
- To a funding agency or other specified agency in accordance with the requirements for audits of entities that receive governmental financial assistance (see paragraphs 10.23 through 10.25)

10.19 When the auditor, as a result of the assessment of the risk of material misstatement due to fraud, has identified risk factors that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether these risk factors represent reportable conditions that relate to the auditee's internal control and that should be communicated to senior management and the audit committee (see paragraphs 10.26 through 10.30). The auditor may also wish to communicate other risk factors that are identified, when the auditee can reasonably take actions to address the risk.

10.20 In paragraphs 38 through 40 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.38–40), the communication requirements of SAS No. 82 are further discussed. In paragraphs 4.32 through 4.37 of this SOP, the other requirements of SAS No. 82 are summarized. See paragraphs 6.7 through 6.12 for a discussion of the auditor's consideration of fraud risk in an audit of an auditee's compliance with specified requirements applicable to its major programs.

Government Auditing Standards Requirements

10.21 With regard to fraud and illegal acts, *Government Auditing Standards* requires auditors to report relevant information (in writing) when the auditor concludes, based on evidence obtained, that fraud or an illegal act has occurred or is likely to have occurred.⁷ Auditors do not need to report information about fraud or illegal acts that is clearly inconsequential. Therefore, auditors are required to present in the report the same fraud and illegal acts that they report to audit committees under GAAS (see paragraphs 10.17 through 10.20). *Government Auditing Standards* also requires auditors to report other

⁷ The term *fraud*, as used in SAS No. 82, is synonymous with *irregularities* as used in *Government Auditing Standards*. Therefore, in discussing the requirements of *Government Auditing Standards*, this SOP will use the term *fraud* instead of the term *irregularities*.

noncompliance (for example, a violation of a contract provision) that is material to the financial statements. In presenting fraud, illegal acts, or other noncompliance that are required to be reported, auditors should follow the report contents standards in chapter 7 of *Government Auditing Standards* for objectives, scope, and methodology; audit results; the views of responsible officials; and report presentation standards (as appropriate).

10.22 When auditors detect fraud, illegal acts, or other noncompliance that do not meet the criteria in paragraph 5.18 of *Government Auditing Standards* for reporting (summarized in paragraph 10.21), paragraph 5.20 of *Government Auditing Standards* requires auditors to communicate those findings to the auditee, preferably in writing. If auditors have communicated those findings in a management letter to top management, they should refer to that management letter when they are reporting on compliance. Auditors should document in their working papers all communications to the auditee about fraud, illegal acts, or other noncompliance.

Direct Reporting of Fraud and Illegal Acts

10.23 Paragraphs 5.21 through 5.25 of *Government Auditing Standards* provide guidance on the direct reporting of fraud and illegal acts. *Government Auditing Standards* requires that in addition to any legal requirements for the direct reporting of fraud or illegal acts, auditors must report fraud or illegal acts directly to parties outside the auditee in the following two circumstances (auditors should meet these requirement even if they have resigned or been dismissed from the audit):

- a. The auditee may be required by law or regulation to report certain fraud or illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general). If auditors have communicated such fraud or illegal acts to the auditee, and it fails to report them, then auditors should communicate their awareness of that failure to the auditee's governing body. If the auditee does not make the required report as soon as practicable after the auditors' communication with its governing body, then the auditors should report the fraud or illegal acts directly to the external party specified in the law or regulation.
- b. When fraud or an illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statement or resign from the audit, then they should communicate that conclusion to the auditee's governing body. Then, if the auditee does not report the fraud or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the fraud or illegal act directly to that entity.

10.24 In both of these situations, auditors should obtain sufficient, competent, and relevant evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported fraud or illegal acts. If they are unable to do so, the auditors should report the fraud or illegal acts directly, as discussed previously.

10.25 Paragraph 4.16 of *Government Auditing Standards* reminds auditors that under some circumstances, laws, regulations, or policies may require

them to report indications of certain types of fraud or illegal acts promptly to law enforcement or investigatory authorities. When auditors conclude that this type of fraud or illegal act either has occurred or is likely to have occurred, they should ask those authorities, legal counsel, or both, if reporting certain information about that fraud or illegal act would compromise investigative or legal proceedings. Auditors should limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

Internal Control Over Financial Reporting

10.26 SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, provides guidance in identifying and reporting conditions that relate to an auditee's internal control observed during an audit of financial statements. In addition to providing guidance on communicating reportable conditions and identifying material weaknesses in the internal control over financial reporting, SAS No. 60 states that because timely communication may be important, the auditor may choose to communicate significant matters related to the internal control over financial reporting during the course of the audit rather than after the audit is concluded.

10.27 Written reporting on internal control matters under *Government Auditing Standards* is based on the auditor's consideration of the internal control over financial reporting as required by SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*. The report does not express an opinion on the auditee's internal control over financial reporting, but rather describes the extent of the work performed, as required by SAS No. 55. The report includes the requirements of SAS No. 60, as well as the additional requirements of *Government Auditing Standards*.

10.28 With regard to matters noted in an audit that relate to the internal control over financial reporting, paragraph 5.26 of *Government Auditing Standards* requires auditors to report deficiencies in internal control that they consider to be reportable conditions as defined by SAS No. 60. Paragraph 17 of SAS No. 60 prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. The illustrative report in example 2 of appendix D provides recommended language that satisfies the requirements of *Government Auditing Standards* when no reportable conditions are noted during an audit. In reporting reportable conditions, auditors are required to identify those that are individually or cumulatively material weaknesses. Auditors should follow the report contents standards in chapter 7 of *Government Auditing Standards* when reporting reportable conditions or material weaknesses. The illustrative report in example 2a of appendix D provides recommended language that satisfies the requirements of *Government Auditing Standards* when reportable conditions (whether or not they are considered to be material weaknesses) are noted during an audit.

10.29 Paragraph 5.28 of *Government Auditing Standards* states that when auditors detect deficiencies in the internal control that are not reportable conditions, they should communicate those deficiencies to the auditee, preferably in writing. If the auditors have communicated those deficiencies in internal control in a management letter to top management, they should refer to that management letter when they report on internal control (examples 2 and

2a of appendix D illustrate such a reference to the management letter). All communications to the auditee about deficiencies in the internal control should be documented in the working papers.

10.30 The following table summarizes the differences between SAS No. 60 and *Government Auditing Standards* with respect to reporting internal control matters.

| | Government Auditing Standards | SAS No. 60 |
|---|------------------------------------|--|
| When is reporting required? | In every financial statement audit | When reportable conditions are noted |
| What is the form of the report? | Written | Oral or written, preferably in writing |
| Should the auditor separately identify those reportable conditions that are significant enough to be material weaknesses? | Yes | Permitted but not required |

Reporting When Portions of a Governmental Reporting Entity Do Not Have an Audit in Accordance With Government Auditing Standards

10.31 Since the implementation of Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, it is becoming more frequent for governments that are required to have an audit in accordance with *Government Auditing Standards* to include as part of the reporting entity component units that are not required to have such an audit. When this occurs, the auditor should consider modifying his or her report on the financial statements and also the report issued to meet the requirements of *Government Auditing Standards*.

10.32 With regard to the report on the financial statements of the reporting entity, if a material component unit or fund is not required to have an audit in accordance with *Government Auditing Standards* and the report on the financial statements is required to state that the audit was performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of the report on the financial statements to indicate the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows:

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

10.33 With regard to the report issued on compliance and on the internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of example 2 or 2a of appendix D to indicate

the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows:

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

Implementing Regulations of Certain Federal Awarding Agencies May Define Entity to Be Audited Differently Than GAAP

10.34 The regulations implementing Circular A-133 may define the entity to be audited for single audit purposes differently than the reporting entity would be defined in accordance with GAAP. For example, SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, requires presentation of consolidated financial statements when one NPO (the parent) controls the voting majority of the Board of and has an economic interest in another NPO. If the regulations of the federal agency that provides federal awards to the parent define the entity for single audit purposes to consist of only the parent, audited parent-only financial statements instead of consolidated financial statements must be submitted to comply with these regulations. If consolidated financial statements are not also prepared as required by GAAP, the auditor should consider whether other than an unqualified opinion due to a material departure from GAAP should be expressed on the parent-only financial statements. See paragraphs 35 through 60 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.35-.60) for guidance on reporting when there is a departure from GAAP.

Opinion on the Financial Statements and on the Supplementary Schedule of Expenditures of Federal Awards

Report Requirements

10.35 The auditor's standard report on the financial statements and on the supplementary schedule of expenditures of federal awards identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion on the financial statements and supplementary schedule of expenditures of federal awards in separate opinion paragraphs. The basic elements of the report are—

- a. A title that includes the word *independent*.
- b. A statement that the financial statements identified in the report were audited.
- c. A statement that the financial statements are the responsibility of the auditee's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit.

- d. A statement that the audit was conducted in accordance with GAAS and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.⁸
- e. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
- f. A statement that an audit includes—
- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
 - Assessing the accounting principles used and significant estimates made by management.
 - Evaluating the overall financial statement presentation.
- g. A statement that the auditor believes that the audit provides a reasonable basis for his or her opinion.
- h. For a government, an opinion on whether the financial statements present fairly, in all material respects, the financial position of the auditee as of the balance sheet date, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the period then ended in conformity with GAAP; for a not-for-profit organization, an opinion on whether the financial statements present fairly, in all material respects, the financial position of the auditee as of the date of the statement of financial position, and the changes in its net assets and its cash flows for the period then ended in conformity with GAAP.⁹
- i. A reference to the separate report on compliance with certain provisions of laws, regulations, contracts, and grant agreements and on the internal control over financial reporting prepared in accordance with *Government Auditing Standards*.¹⁰ If this reporting is included in the report on the financial statements, this reference is not required (this SOP recommends separate reporting). See paragraph 10.16.
- j. A description of the accompanying supplementary information (for example, the schedule of expenditures of federal awards, combining and individual fund and account group financial statements and schedules, etc.). This identification may be by descriptive title or by page number of the document.
- k. A statement that the accompanying supplementary information, including the schedule of expenditures of federal awards required by Circular A-133, is presented for purposes of additional analysis and is not a required part of the financial statements.¹¹ See paragraph 10.36.

⁸ See footnote 3.

⁹ If an auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP, the auditor is still required to express or disclaim an opinion and should follow the reporting in SAS No. 62, *Special Reports*.

¹⁰ See paragraphs 10.15, 10.16, and 10.21 through 10.30 for a discussion of reporting on compliance and on the internal control based on a financial statement audit in accordance with *Government Auditing Standards*.

¹¹ If the report on the financial statements is issued for an audit that is not subject to Circular A-133 (that is, an audit in accordance with GAAS and *Government Auditing Standards* only), this reference to the schedule of expenditures of federal awards and Circular A-133 should be deleted.

- l. An opinion on whether the accompanying supplementary information is fairly stated, in all material respects, in relation to the financial statements taken as a whole.
- m. The manual or printed signature of the auditor's firm.
- n. The date of the audit report.

Reporting on the Schedule of Expenditures of Federal Awards

10.36 This SOP recommends that the auditor report on the schedule of expenditures of federal awards in the report on the financial statements. However, some entities do not present the schedule with the financial statements (that is, a separate single audit package is issued). In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. Examples 3 (footnote 34) and 3a (footnote 40) of appendix D, illustrate how to incorporate the reporting on the schedule into the Circular A-133 report. See also paragraphs 10.50 through 10.52 for information on dating the reports in this situation and paragraph 10.13 for a further discussion of reporting on the schedule.

10.37 Examples of the auditor's opinion on the financial statements and on the supplementary schedule of expenditures of federal awards are presented in examples 1 and 1a of appendix D.

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

10.38 This SOP recommends that the reporting on the scope of the auditor's testing of compliance and on the internal control over financial reporting based on an audit of the financial statements as required by *Government Auditing Standards* be combined in one report (see paragraphs 10.8 through 10.10).

10.39 The basic elements of the auditor's standard report on compliance and on the internal control over financial reporting (see paragraph 4.12) based on an audit of the financial statements in accordance with *Government Auditing Standards* are—

- a. A statement that the auditor has audited the financial statements of the auditee and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the audit was conducted in accordance with GAAS and with the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.¹²
- c. A statement that as part of obtaining reasonable assurance about whether the auditee's financial statements are free of material misstatement, the auditor performed tests of the auditee's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.

¹² See footnote 3.

- d. A statement that providing an opinion on compliance with those provisions was not an objective of the audit and that, accordingly, the auditor does not express such an opinion.
- e. A statement that notes whether the results of tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*¹³ and, if they are, describes the instances of noncompliance or refers to the schedule of findings and questioned costs in which they are described.¹⁴
- f. If applicable, a statement that certain immaterial instances of non-compliance were communicated to management in a separate letter.¹⁵
- g. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over financial reporting in order to determine the auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.
- h. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.
- i. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.
- j. If applicable, a description of the reportable conditions noted or a reference to the schedule of findings and questioned costs in which the reportable conditions are described.¹⁶
- k. The definition of a material weakness.
- l. If applicable, a statement about whether the auditor believes any of the reportable conditions noted are material weaknesses and, if they are, describes the material weaknesses noted or refers to the schedule of findings and questioned costs in which they are described.¹⁷ If there are no reportable conditions noted, a statement is made that no material weaknesses were noted.

¹³ See paragraph 10.21 for a discussion of noncompliance matters that need to be reported under *Government Auditing Standards*.

¹⁴ For an audit that is not subject to Circular A-133 (that is, in accordance with *Government Auditing Standards* only), any reportable instances of noncompliance, reportable conditions, and material weaknesses can either be described in the body of the report or the report can refer to a separate schedule that summarizes the findings noted. This statement should be modified accordingly. For an audit in accordance with Circular A-133, all findings, including those required to be reported under *Government Auditing Standards*, must be included in the schedule of findings and questioned costs.

¹⁵ See paragraph 10.22 for a discussion of reporting other noncompliance matters to top management in accordance with *Government Auditing Standards*.

¹⁶ See footnote 14.

¹⁷ See footnote 14.

- m. If applicable, a statement that other matters involving the internal control over financial reporting were communicated to management in a separate letter.¹⁸
- n. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the audit committee, management, specified legislative or regulatory bodies, federal awarding agencies, and (if applicable) pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.^{19, 20}
- o. The manual or printed signature of the auditor's firm.
- p. The date of the auditor's report.

10.40 Examples of the auditor's report on compliance and on the internal control over financial reporting based on an audit of the financial statements in accordance with *Government Auditing Standards* are included in examples 2 and 2a of appendix D.

Reporting on a Compliance Audit of Major Federal Programs

10.41 In this section the auditor's reports that are issued based on a compliance audit of major programs in accordance with Circular A-133 are discussed. The report on compliance with requirements applicable to major programs expresses the auditor's opinion on whether the auditee complied with the requirements that, if noncompliance occurred, could have a direct and material effect on a major program. Although the guidance in SAS No. 58 addresses reporting on audited financial statements, auditors may find its guidance useful when reporting on a compliance audit of major programs.

Material Instances of Noncompliance

10.42 When the audit of an auditee's compliance with requirements applicable to a major program detects material instances of noncompliance with those requirements, the auditor should express a qualified or adverse opinion. The auditor should state the basis for such an opinion in the report (see examples 3a and 5 of appendix D). The auditor should also consider the cumulative effect of all instances of noncompliance on the financial statements. See paragraphs 6.13 through 6.16 for a further discussion of material instances of noncompliance.

Scope Limitations

10.43 Testing an auditee's compliance with laws, regulations, and the provisions of contracts or grant agreements (referred to as "compliance require-

¹⁸ See paragraph 10.29 for a discussion of other internal control matters to be communicated to top management in accordance with *Government Auditing Standards*.

¹⁹ For an audit that is not subject to Circular A-133 (that is, in accordance with *Government Auditing Standards* only), the reference to federal awarding agencies and pass-through entities should be deleted.

²⁰ This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports.

ments”) requires the auditor to make a comply/noncomply decision about an auditee’s adherence to those compliance requirements. The auditor is able to express an unqualified opinion only if he or she has been able to apply all the procedures the auditor considers necessary in the circumstances. Restrictions on the scope of the audit—whether imposed by the client or by circumstances such as the timing of the auditor’s work, an inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records—may require auditors to qualify their opinion or to disclaim an opinion. In these instances, the reasons for such a qualification or disclaimer of opinion should be described in the auditor’s report. Furthermore, the auditor should consider the effects of such instances on his or her ability to express an unqualified opinion on the financial statements. See example 4 of appendix D for an illustration of a qualified opinion on compliance due to a scope limitation.

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

10.45 When disclaiming an opinion because of a scope limitation, the auditor should indicate in a separate paragraph all of the substantive reasons for the disclaimer. The auditor should state that the scope of his or her audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed or include a paragraph describing the characteristics of an audit (that is, the scope paragraph); to do so may tend to overshadow the disclaimer. In addition, the auditor should disclose any reservations he or she has regarding compliance with applicable laws and regulations.

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With Circular A-133

Report Requirements

10.46 The basic elements of the auditor’s standard report on compliance with requirements applicable to each major program and on the internal control over compliance (see paragraph 4.12) in accordance with Circular A-133 are—

- a. A statement that the auditor has audited the compliance of the auditee with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that are applicable to each of its major programs.
- b. A statement that the auditee’s major programs are identified in the summary of the auditor’s results section of the accompanying schedule of findings and questioned costs (see paragraph 10.56).
- c. A statement that compliance with the requirements of laws, regulations, contracts, and grants applicable to each of the auditee’s major

federal programs is the responsibility of the auditee's management, and that the auditor's responsibility is to express an opinion on the auditee's compliance based on the audit.

- d. A statement that the audit of compliance was conducted in accordance with GAAS, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States,²¹ and Circular A-133.
- e. A statement that those standards and Circular A-133 require that the auditor plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements that could have a direct and material effect on a major federal program occurred.
- f. A statement that an audit includes the examining, on a test basis, evidence about the auditee's compliance with those requirements and performing of such other procedures as the auditor considered necessary in the circumstances.
- g. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion.
- h. A statement that the audit does not provide a legal determination of the auditee's compliance with those requirements.
- i. If instances of noncompliance are noted that result in an opinion modification, a reference to a description in the accompanying schedule of findings and questioned costs, including—
 - The reference number(s) of the finding(s).
 - An identification of the type(s) of compliance requirements and related major program(s).
 - A statement that compliance with such requirements is necessary, in the auditor's opinion, for the auditee to comply with the requirements applicable to the program(s).
- j. An opinion on whether the auditee complied, in all material respects, with the types of compliance requirements that are applicable to each of its major federal programs.
- k. If applicable, a statement that the results of the auditing procedures disclosed instances of noncompliance that are required to be reported in accordance with Circular A-133 and a reference to the schedule of findings and questioned costs in which they are described.²²
- l. A statement that the auditee's management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs.
- m. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over compliance with requirements that could have a direct and material effect on a major

²¹ See footnote 3.

²² See paragraph 10.63 for a discussion of the audit findings that are required to be reported under Circular A-133.

federal program, to determine the auditing procedures for the purpose of expressing an opinion on compliance and to test and report on the internal control over compliance in accordance with Circular A-133.

- n. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.
- o. If applicable, a reference to a description of reportable conditions noted in the accompanying schedule of findings and questioned costs, including the reference number of the finding(s).
- p. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over compliance would not necessarily disclose all matters in internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.
- q. The definition of a material weakness.
- r. If applicable, a statement about whether the auditor believes any of the reportable conditions noted are material weaknesses and, if they are, a reference to a description of the material weaknesses in the schedule of findings and questioned costs, including the reference number of the finding(s). If there are no reportable conditions, a statement is made that no material weaknesses were noted.
- s. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the audit committee, management, specified legislative or regulatory bodies, federal awarding agencies, and (if applicable) pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.²³
- t. The manual or printed signature of the auditor's firm.
- u. The date of the auditor's report.

Option to Report on the Schedule of Expenditures of Federal Awards

10.47 This SOP recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, in certain circumstances (for example, when a separate single-audit package is issued), the required reporting on the schedule may be incorporated into the report described in paragraph 10.46. See paragraph 10.36 for a further discussion. Examples 3 (footnote 34) and 3a (footnote 40) of appendix D, illustrate this reporting option.

No Requirement to Refer to Management Letter

10.48 It is important to note that all audit findings required to be reported under Circular A-133 must be included in the schedule of findings and questioned costs (see paragraphs 10.55 and 10.56). A separate letter (that is,

²³ This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports.

management letter) may not be used to communicate such matters to top management in lieu of reporting them as audit findings in accordance with Circular A-133. Since all reportable findings are included in the schedule, there is no requirement for the auditor to refer to the management letter in the report described in paragraph 10.46.

10.49 An example of the auditor's report on compliance with requirements applicable to each major program and on the internal control over compliance in accordance with Circular A-133 is presented in examples 3, 3a, 4, and 5 of appendix D.

Other Reporting Considerations

Dating of Reports

10.50 Since the report on the supplementary schedule of expenditures of federal awards indicates that the auditor is reporting "in relation to" the basic financial statements, it should carry the same date as that on the report on these statements. Furthermore, since the report on compliance and internal control over financial reporting, as required by *Government Auditing Standards*, relates to the audit of the financial statements and is based on the GAAS audit procedures performed, it should also carry the same date.

10.51 The auditor's report on compliance and on the internal control over compliance related to major programs, as required by Circular A-133, should ordinarily have the same date as that of the other reports, but may carry a later date, because some of the audit work to satisfy Circular A-133 requirements may be done subsequent to the work on the financial statements. When this is the case, the reporting required by Circular A-133 should be dated at the later date (that is, when the fieldwork required to support the report on the audit of compliance is completed). The auditor should perform subsequent events procedures from the date of the report on the financial statements to the date of the report on the compliance audit in accordance with SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560). If, after issuing the report on the financial statements, the auditor becomes aware of instances of noncompliance that could be material to such statements, he or she should follow the guidance in SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 561).

10.52 This SOP recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, as noted in paragraphs 10.36 and 10.47, there may be circumstances in which the auditor reports on the schedule in the report on compliance and the internal control over compliance issued to meet Circular A-133 requirements. In this situation, the report issued to meet Circular A-133 requirements must be dated the same as the report on the financial statements. This is because the report on the schedule is "in relation to" the basic financial statements. If using the same date is not possible because the work to satisfy Circular A-133 requirements is not complete as of the date of the financial statement report, the auditor has two options:

- a. The auditor can dual date the report issued to meet Circular A-133 requirements. The date relating to the portion of the report pertain-

ing to the schedule of expenditures of federal awards would be the same as the date of the financial statement report. The date pertaining to the remainder of the report would be the date on which the work done to satisfy Circular A-133 requirements is completed. Refer to SAS No. 1, section 530 *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530).

- b. The auditor can issue a separate report on the schedule of expenditures of federal awards, dated the same date as that of the financial statement report.

In some instances, the auditor may be engaged to issue a stand-alone opinion on the schedule either as part of the report issued to meet the requirements of Circular A-133 or separately (dated the same as the Circular A-133 report). The auditor should follow the guidance in SAS No. 58 when issuing such a report.

Other Auditors

10.53 When more than one independent auditor is involved in a single audit performed under Circular A-133, the auditor should refer to guidance in paragraphs 12 and 13 of SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508.12 and .13) regarding an opinion on financial statements based in part on the report of another auditor, as well as SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543).

When the Audit of Federal Awards Does Not Encompass the Entirety of the Auditee's Operations

10.54 If the audit of federal awards did not encompass the entirety of the auditee's operations expending federal awards, the operations that are not included should be identified in a separate paragraph following the first paragraph of the report on major programs (see also the discussion in paragraph 3.25). An example of such a paragraph follows:

Example Entity's general-purpose financial statements include the operations of the [identify component unit or department], which received [include dollar amount] in federal awards which is not included in schedule during the year ended June 30, 19X1. Our audit, described below, did not include the operations of [identify component unit or department] because [state the reason for the omission, such as the component unit engaged other auditors to perform an audit in accordance with OMB Circular A-133].

Schedule of Findings and Questioned Costs

10.55 Circular A-133 requires the auditor to prepare a schedule of findings and questioned costs, which should include the following three sections:

- a. A summary of the auditor's results
- b. Findings relating to the financial statements which are required to be reported in accordance with *Government Auditing Standards*
- c. Findings and questioned costs for federal awards

What Should Be Reported

10.56 Specifically, Circular A-133 requires the schedule of findings and questioned costs to contain—

- a. A summary of the auditor's results, which must include—

- The type of report the auditor issued on the financial statements of the auditee (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.²⁴
 - A statement on whether the audit disclosed any noncompliance that is material to the financial statements of the auditee.
 - Where applicable, a statement that reportable conditions in the internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.²⁵
 - The type of report the auditor issued on compliance for major programs (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - A statement on whether the audit disclosed any audit findings that the auditor is required to report under section 510(a) of Circular A-133 (see paragraph 10.63).
 - An identification of major programs.
 - The dollar threshold used to distinguish between type A and type B programs as described in section 520(b) of Circular A-133 (see paragraphs 7.4 through 7.9).
 - A statement on whether the auditee qualified as a low-risk auditee under section 530 of Circular A-133 (see paragraph 7.25).
- b. Findings relating to the financial statements which are required to be reported in accordance with *Government Auditing Standards* (see the discussion in paragraphs 10.57 through 10.62 for further detail).
- c. Findings and questioned costs for federal awards, which must include audit findings as defined in section 510(a) of Circular A-133 (see paragraph 10.63). Circular A-133 also requires the following with regard to this section of the schedule:
- Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as a single audit finding. Where practical, audit findings should be organized by federal agency or pass-through entity.
 - Audit findings that relate to both the financial statements and the federal awards should be reported in both sections of the schedule. However, the reporting in one section of the schedule may be in summary form, with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that affects the auditee as a whole, including its federal awards, should usually be reported in detail

²⁴ Auditors should note that SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, precludes an auditor from issuing a written report representing that no reportable conditions were noted during an audit. Therefore, the sample schedule of findings and questioned costs included in appendix E uses the term "none reported" to indicate that no reportable conditions were included in the auditor's report (versus "none," which would imply that there were no reportable conditions).

²⁵ See footnote 24.

in the section of the schedule of findings and questioned costs that is related to the financial statements, with a summary identification and reference given in the section related to federal awards. Conversely, a finding of noncompliance with a federal program law that is also material to the financial statements should be reported in detail in the federal awards section of the schedule, with a summary identification and reference given in the financial statement section.

Findings Relating to the Financial Statements

10.57 As noted before, Circular A-133 requires the schedule of findings and questioned costs to include a section that reports the findings relating to the financial statements (note that these findings must also be addressed in the auditor's report issued to meet the requirements of *Government Auditing Standards*—see paragraphs 10.15, 10.16, and 10.21 through 10.30). This section of the schedule should include all reportable conditions in the internal control over financial reporting and other findings relative to the audit of the financial statements that are required to be reported by GAAS and *Government Auditing Standards*, including those that do not affect federal awards. In addition to requiring auditors to report reportable conditions in the internal control over financial reporting, *Government Auditing Standards* requires auditors to report all but clearly inconsequential fraud and illegal acts that the auditor concludes, based on the evidence obtained, either occurred or are likely to have occurred. *Government Auditing Standards* also requires the auditor to report other noncompliance (for example, violations of the provisions of contract or grant agreements) that is material to the financial statements (see paragraphs 10.21 and 10.22).

10.58 In reporting reportable conditions, fraud, illegal acts, and other noncompliance, auditors should place their findings in proper perspective. This perspective is both quantitative and qualitative. To give the reader a basis to judge the prevalence and consequences of these conditions, the instances that are identified should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate. Reportable conditions that are—either individually or in the aggregate—material weaknesses should be so identified.

10.59 *Government Auditing Standards* suggests that well-developed findings generally include the following elements:

- Criteria (what should be)
- The condition (what is)
- The effect (the difference between what is and what should be)
- The cause (why it happened)

10.60 *Government Auditing Standards* recognizes reportable conditions and noncompliance identified by the auditor may not always have all of the elements fully developed. However, to provide sufficient information to users to permit them to determine the effect and cause in order to take prompt and proper corrective action, auditors should identify at least the criteria, condition, and possible asserted effect.

10.61 In presenting reportable conditions, fraud, illegal acts, and other noncompliance, auditors should follow the report content standards in chapter 7 of *Government Auditing Standards* that pertain to objectives, scope, and meth-

odology; audit results; the views of responsible officials; and the reports presentation standards (as appropriate). Auditors may provide less extensive disclosure of fraud and illegal acts that are not material in either a quantitative or qualitative sense.

10.62 *Government Auditing Standards* also requires the auditor to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit (see paragraph 6.65 for a discussion of the auditor's responsibility for audit follow-up under *Government Auditing Standards*). The auditor should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit. Material findings and recommendations from previous audits that are repeated as current-year findings should be identified as repeat findings. If there are uncorrected findings from previous audits that are not repeated as current-year findings, their status should also be reported by the auditor. In either case, this information should be provided for in the section of the schedule of findings and questioned costs related to the financial statements.

Audit Findings Reported—Federal Awards

10.63 Section 510(a) of Circular A-133 requires the auditor to report as audit findings in the schedule of findings and questioned costs—

- a. Reportable conditions in the internal control over major programs. The auditor's determination of whether a deficiency in internal control is a reportable condition for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or to an audit objective identified in the *Compliance Supplement*. The auditor should identify reportable conditions that are individually or cumulatively material weaknesses (see paragraphs 8.25 and 8.26).
- b. Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements that are related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement* (see paragraphs 6.51 through 6.60 for a further discussion of the evaluation and reporting of noncompliance).
- c. Known questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor should consider the best estimate of the total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). The auditor should also report (in the schedule of findings and questioned costs) known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program. For example, if the auditor specifically identifies \$7,000 in questioned costs but, based on his or her evaluation of the effect of questioned costs on the opinion on compliance, estimates that the

total questioned costs are in the \$50,000–\$60,000 range, the auditor should report a finding that identifies the known questioned costs of \$7,000. Although the auditor is not required to report his or her estimate of the total questioned costs, the auditor should include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

- d. Known questioned costs that are greater than \$10,000 for programs that are not audited as major. Since (except for audit follow-up) the auditor is not required to perform audit procedures for federal programs that are not major, the auditor will normally not find questioned costs. However, if the auditor does become aware of questioned costs for a federal program that is not audited as a major program (for example, as part of audit follow-up or other audit procedures) and the known questioned costs are greater than \$10,000, then the auditor should report this as an audit finding.
- e. The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for federal awards (for example, a scope limitation that is not otherwise reported as a finding).
- f. Known fraud affecting a federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of *Government Auditing Standards* (see paragraphs 10.23 through 10.25).
- g. Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in accordance with section 315(b) of Circular A-133 materially misrepresents the status of any prior audit finding (see paragraphs 10.68 through 10.70).

Detail of Audit Findings—Federal Awards

10.64 Section 510(b) of Circular A-133 requires that audit findings should be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for federal agencies and pass-through entities to arrive at a management decision. The specific information that Circular A-133 requires in audit findings consists of (as applicable)—

- a. Identification of the federal program and specific federal award including the CFDA title and number, the federal award number and year, the name of federal agency, and the name of the applicable pass-through entity. When information such as the CFDA title and number or the federal award number is not available, the auditor should provide the best information available to describe the federal award.
- b. The criteria or specific requirement upon which the audit finding is based, including the statutory, regulatory, or other citation.

- c. The condition found, including facts that support the deficiency identified in the audit finding.
- d. Identification of questioned costs and how they were computed.
- e. Information to provide a proper perspective for judging the prevalence and consequences of the audit findings, (for example, whether the audit findings represent an isolated instance or a systemic problem). Where appropriate, the instances identified should be related to the universe and the number of cases examined and be quantified in terms of the dollar value.
- f. The possible asserted effect to provide sufficient information to the auditee and federal agency (or pass-through entity, in the case of a subrecipient) to permit them to determine the cause and effect, to facilitate prompt and proper corrective action.
- g. Recommendations to prevent future occurrences of the deficiency identified in the audit finding.
- h. To the extent practical, the views of responsible officials of the auditee when there is disagreement with the audit findings. If the auditee's corrective action plan is available and contains the views of the responsible officials, the auditor can indicate in the finding that the auditee disagreed with the finding and refer to the details of the auditee's position in the corrective action plan. However, if the auditor does not agree with the auditee's position, the auditor should state his or her reasons for rejecting it.

Other Preparation Guidance

10.65 Each audit finding in the schedule of findings and questioned costs should include a reference number to allow for easy referencing of the audit findings during follow-up. One option for assigning reference numbers is to use the last two digits of the fiscal year being audited as the first two digits of each reference number, followed by a numeric sequence. For example, findings identified and reported in the audit of fiscal year 199X would be assigned reference numbers 9X-1, 9X-2, etc.

10.66 A schedule of findings and questioned costs must be issued for every single audit, regardless of whether any findings or questioned costs are noted. This is because Circular A-133 requires that one section of the schedule summarize the audit results (see paragraphs 10.55 and 10.56). In a situation in which there are no findings or questioned costs, the auditor should prepare the summary of auditor's results section of the schedule and indicate in the other required sections that no matters were reportable.

10.67 Appendix E contains an illustrative schedule of findings and questioned costs.

Summary Schedule of Prior Audit Findings and Corrective Action Plan

10.68 The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee is required to prepare

a summary schedule of prior audit findings. The auditee is not required to prepare a summary schedule of prior audit findings if there are no matters reportable therein. However, to best serve the needs of federal agencies and to avoid any potential future misunderstanding or allegation of nonconformity with the requirements of Circular A-133, the auditee may consider preparing in this circumstance a summary schedule circumstance that indicates that no matters are reportable. The auditee is also required to prepare a corrective action plan for each of the current-year audit findings. The summary schedule of prior audit findings and the corrective action plan, which are both part of the reporting package, must include the reference numbers the auditor assigns to audit findings in the schedule of findings and questioned costs. This numbering (or other identification) should include the fiscal year in which the finding initially occurred.

10.69 The auditor is required to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of section 500(e) of Circular A-133 (see paragraphs 6.61 through 6.65).

10.70 The auditor has no responsibility for the corrective action plan; however, the auditor may be separately engaged by the auditee for assistance in developing appropriate corrective actions in response to audit findings. The auditor may find the auditee's corrective action plan useful in performing follow-up on prior audit findings (in addition to the schedule of prior audit findings), because it may provide an indication of the corrective steps planned by the auditee.

Data Collection Form

10.71 Circular A-133 requires the auditee to complete and sign certain sections of a data collection form that states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit. This form is not part of the reporting package (see paragraph 10.7). The information required to be included in the form, however, represents a summary of the information contained in the reporting package, including the auditor's reports and the auditee's schedule of expenditures of federal awards.

10.72 The auditor is also required to complete certain sections of the form, including information on the auditor and information on the results of the financial statement audit and the audit of federal programs. The auditor is also required to sign a statement in the form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package, and that the content of the form is limited to the data elements prescribed by the OMB. As part of completing the form, the auditor is asked to date it. The date that is entered by the auditor should be the date on which he or she completes and signs the form. The wording of the auditor's statement section of the form indicates that no additional procedures were performed since the date of the audit reports. This wording alleviates the auditor from any subsequent-event responsibility with regard to the timing of the completion of the form and the

completion of the audit. The form includes detailed instructions, which should be carefully followed by the auditor.

10.73 The data collection form and related instructions are available on the OMB's home page at www.whitehouse.gov/WH/EOP/OMB/Grants (note that this address is "case sensitive," that is, upper- and lowercase letters must be as shown). A copy of the form and instructions can also be obtained from the Federal Audit Clearinghouse at (888) 222-9907. The form number is SF-SAC.²⁶

Submission of Reporting Package and Data Collection Form

10.74 The submission of the data collection form and the reporting package, including the audit reports, is the responsibility of the auditee. The data collection form and the reporting package must be submitted by the auditee within the earlier of thirty days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. However, it should be noted that Circular A-133 includes a delayed implementation date for report-submission deadlines. For fiscal years beginning on or before June 30, 1998, the audit must be completed and the data collection form and reporting package must be submitted within thirty days after the receipt of the auditor's reports, or thirteen months after the end of the audit period.

Submission to Clearinghouse

10.75 All auditees must submit to the federal clearinghouse designated by the OMB the data collection form and one copy of the reporting package (see paragraph 10.6 for a description) for (a) the federal clearinghouse to retain as an archival copy and (b) each federal awarding agency, when the schedule of findings and questioned costs disclosed audit findings relating to federal awards that the federal awarding agency provided directly or when the summary schedule of prior audit findings reported the status of any audit findings relating to federal awards that the federal awarding agency provided directly.

Submission by Subrecipients

10.76 In addition to the requirements in paragraph 10.75, auditees that are also subrecipients must submit to each pass-through entity one copy of the reporting package for each pass-through entity when the schedule of findings and questioned costs disclosed audit findings relating to federal awards that the pass-through entity provided or when the summary schedule of prior audit findings reported the status of any audit findings relating to federal awards that the pass-through entity provided. When a subrecipient is not required to submit a reporting package to a pass-through entity, the subrecipient must instead provide written notification to the pass-through entity that—

²⁶ As of the issuance of this SOP, the Federal Audit Clearinghouse is developing the data collection form in various word processing packages, as well as a process for electronic submission. Auditors can review the Federal Audit Clearinghouse home page at <http://harvester.census.gov/sac> for the most current information on these developments.

- An audit of the subrecipient was conducted in accordance with Circular A-133 (including the period covered by the audit and the name, amount, and CFDA number of the federal awards provided by the pass-through entity).
- The schedule of findings and questioned costs disclosed no audit findings relating to the federal awards that the pass-through entity provided.
- The summary schedule of prior audit findings did not report on the status of any audit findings relating to the federal awards that the pass-through entity provided.

A subrecipient may submit a copy of the reporting package to a pass-through entity to comply with this notification.

Requests for Copies

10.77 In response to a request by a federal agency or pass-through entity, auditees should submit the appropriate copies of the reporting package and, if requested, a copy of any management letters issued by the auditor.

Report Retention Requirements

10.78 Auditees are required to keep one copy of the data collection form and the reporting package on file for three years from the date of submission to the federal clearinghouse designated by the OMB. Pass-through entities should keep subrecipients' submissions on file for three years from the date of receipt.

Clearinghouse Address

10.79 The name and address of the federal clearinghouse currently designated by the OMB are as follows: Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th St., Jeffersonville, IN 47132.

Freedom of Information Act

10.80 In accordance with the principles of the Freedom of Information Act (U.S. Code title 5, section 552), audit agency and nonfederal reports issued to grantees and contractors are available, if they are requested, to members of the press and the general public, to the extent that the information contained in them is not subject to exemptions of the act that the cognizant agency for audit chooses to exercise. Accordingly, the auditor should not include names, social security numbers, other personal identification, or other potentially sensitive matters in either the body of the report or any attached schedules.

Chapter 11

PROGRAM-SPECIFIC AUDITS

11.1 A program-specific audit is an audit of an individual federal program (rather than a single audit of an entity's financial statements and federal programs). Section 235 of Circular A-133 provides guidance on program-specific audits.

Use of a Program-Specific Audit to Satisfy Circular A-133 Audit Requirements

11.2 Circular A-133 states that when an auditee expends federal awards under only one federal program (excluding research and development) and the federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit performed in accordance with section 235 of the circular.¹ Therefore, the auditor should determine whether there is a financial statement audit requirement before performing a program-specific audit. A program-specific audit may not be elected for research and development unless all federal awards expended were received from the same federal agency (or the same federal agency and the same pass-through entity) and that federal agency (or pass-through entity, in the case of a subrecipient) approves a program-specific audit in advance.

Program-Specific Audit Requirements

11.3 Circular A-133 requires program-specific audits to be subject to the following sections of Circular A-133 as they may apply to program-specific audits, unless contrary to the provisions of section 235 of Circular A-133, a federal program-specific audit guide, or the program's laws and regulations:

- Purpose; definitions; audit requirements; basis for determining the federal awards expended; subrecipient and vendor determinations; relation to other audit requirements (sections 100 through 215(b))
- Frequency of audits; sanctions; audit costs (sections 220 through 230)
- Auditee responsibilities; auditor selection (sections 300 through 305)
- Follow-up on audit findings (section 315)
- Submission of report (sections 320(f) through 320(j))
- Responsibilities of federal agencies and pass-through entities; management decisions (sections 400 through 405)
- Audit findings and audit working papers (sections 510 through 515)

Program-specific audits are also subject to other provisions, referred to in section 235 of the circular.

¹ An example of a situation where a program-specific audit would not be allowed would be a not-for-profit college that receives SFA (and no other federal awards). This is because the Higher Education Act of 1965, as amended, requires institutions that receive SFA to undergo an annual financial statement audit.

Availability of Program-Specific Audit Guides

11.4 In many cases, a federal agency's Office of Inspector General will have issued a program-specific audit guide that provides guidance on internal control, compliance requirements, suggested audit procedures, and audit reporting requirements for a particular federal program. The auditor should contact the Office of Inspector General of the federal agency to determine whether such a guide is available and current. When a current program-specific audit guide is available, the auditor should follow *Government Auditing Standards* and the guide when performing a program-specific audit. However, if there have been significant changes made to a program's compliance requirements and the related program-specific audit guide has not been updated with regard to the changes, the auditor should follow section 235 of Circular A-133 and the *Compliance Supplement* in lieu of an outdated guide. If a guide is current with regard to a program's compliance requirements but has not been updated to conform to current authoritative standards and guidance (such as current revisions of GAAS or *Government Auditing Standards*), the auditor should follow current applicable professional standards and guidance in lieu of the outdated or inconsistent standards and guidance in the guide.

11.5 When a program-specific audit guide is not available, the auditee and the auditor have basically the same responsibilities for the federal program as they have for an audit of a major program in a single audit as discussed in chapters 6 and 8 of this SOP.

Auditee's Responsibilities When a Program-Specific Audit Guide is Not Available

11.6 In addition to having the responsibilities included in the sections of Circular A-133 that are described in paragraph 11.3, the auditee is required to prepare the following:

- The financial statements for the federal program, which include, at a minimum, a schedule of expenditures of federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule
- A summary schedule of prior audit findings consistent with the requirements of section 315(b) of Circular A-133 (see paragraphs 10.68 through 10.70)
- If applicable, a corrective action plan consistent with the requirements of section 315(c) of the circular (see paragraphs 10.68 through 10.70)

Auditor's Responsibilities When a Program-Specific Audit Guide is Not Available

Audit Scope and Requirements

11.7 Circular A-133 requires the auditor to—

- Perform an audit of the financial statement(s) for the federal program in accordance with *Government Auditing Standards* (see chapter 4 of this SOP for guidance on financial statement audits). See paragraph 11.10 for a further discussion of *Government Auditing Standards*.

- Obtain an understanding of the internal control over compliance and perform tests of the internal control over compliance for the federal program, so that they are consistent with the requirements of section 500(c) of the circular for a major program (see chapter 8 of this SOP for guidance on the internal control considerations for major programs).
- Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program consistent with the requirements of section 500(d) of the circular for a major program (see chapter 6 of this SOP for guidance on the compliance-auditing considerations for major programs).
- Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings that has been prepared by the auditee, and when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding, report this as a current-year audit finding, in accordance with the requirements of section 500(e) of the circular (see paragraphs 10.69 through 10.70).

Auditor's Reports

Circular A-133 Requirements

11.8 Circular A-133 states that the auditor's reports may be in the form of either combined or separate reports and may be organized differently from the manner described below. The auditor's reports should state that the audit was conducted in accordance with GAAS, *Government Auditing Standards*, and Circular A-133 and should include the following:

- An opinion (or disclaimer of opinion) on whether the financial statement(s) of the federal program are presented fairly in all material respects in conformity with the stated accounting policies
- A report on the internal control related to the federal program, which describes the scope of the testing of the internal control and the results of the tests
- A report on compliance, which includes an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program
- A schedule of findings and questioned costs for the federal program, which includes a summary of the auditor's results relative to the audit of the federal program in a format consistent with the requirements for the summary of auditor's results in section 505(d)(1) of the circular, as well as findings and questioned costs for federal awards consistent with the requirements of section 505(d)(3) of the circular (see paragraph 10.55 and 10.56)

Recommended Auditor's Reports

11.9 In an effort to make program-specific audit reporting understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued for a program-specific audit (a) an opinion on the financial statement(s) of the federal program and (b) a report on compli-

ance with requirements applicable to the federal program and on the internal control over compliance in accordance with the program-specific audit option under OMB Circular A-133. See the following paragraph for a discussion of the possible issuance of a third report to meet the reporting requirements of *Government Auditing Standards*. Illustrations of program-specific audit reports are included in examples 6 and 6a of appendix D.

Reporting in Accordance With Government Auditing Standards

11.10 If the financial statement(s) of the program only present the activity of the federal program, the auditor is not required to issue a separate report to meet the reporting requirements of *Government Auditing Standards*. This is because, in many cases, by definition the financial statements of the program consist only of the schedule of expenditures of federal awards. In this situation, examples 6 and 6a of appendix D, would meet the financial, compliance, and internal control over compliance reporting requirements of both *Government Auditing Standards* and Circular A-133. However, it should be noted that the auditor always has the option of issuing a separate *Government Auditing Standards* report (in addition to the two reports described in paragraph 11.9). Although it is not as common, the financial statement(s) of the federal program may present more than the program's activity (for example, a municipal sewer district issues financial statements that include both normal operations and the federal program activity related to a grant for the purpose of building a new sewage-treatment facility). In this situation, the auditor should issue a separate *Government Auditing Standards* report (example 2 or 2a of appendix D), and modify it so that it refers only to the financial statement(s) of the federal program.

Submission of Report

Timing of Submission

11.11 Circular A-133 requires the audit to be completed and the reporting required by sections 235(c)(2) and 235(c)(3) of the circular to be submitted, within the earlier of thirty days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the federal agency that provided the funding or unless a different period is specified in a program-specific audit guide.² Unless restricted by law or regulation, Circular A-133 requires the auditee to make copies of the report available for public inspection.

Submission When a Program-Specific Audit Guide is Available

11.12 When a program-specific audit guide is available, the auditee must submit to the federal clearinghouse designated by the OMB (see paragraph 10.79) the data collection form prepared in accordance with section 320(b) of the Circular (see paragraphs 10.71 through 10.73), as applicable for a program-specific audit, and must also submit the reporting that is required by the pro-

² It should be noted that Circular A-133 includes a delayed implementation date for deadlines for the submission of reports. For fiscal years beginning on or before June 30, 1998, the audit must be completed and the required reports submitted within the earlier of thirty days after the receipt of the auditor's report or thirteen months after the end of the audit period.

gram-specific audit guide which is to be retained as an archival copy. The auditee must also submit to the federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

Submission When a Program-Specific Audit Guide is Not Available

11.13 When a program-specific audit guide is not available, the reporting package for a program-specific audit consists of the following:

- The financial statement(s) of the federal program
- A summary schedule of prior audit findings (see paragraphs 10.68 through 10.70)
- A corrective action plan (see paragraphs 10.68 through 10.70)
- The auditor's report(s) described in paragraphs 11.8 through 11.10

11.14 The data collection form, as applicable to a program-specific audit, and one copy of the reporting package must be submitted to the federal clearinghouse designated by the OMB (see paragraph 10.79), to be retained as an archival copy. Furthermore, when the schedule of findings and questioned costs discloses audit findings or the summary schedule of prior audit findings reports the status of any audit findings, the auditee must submit one copy of the reporting package to the federal clearinghouse on behalf of the federal awarding agency or, in the case of a subrecipient, directly to the pass-through entity. When a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient is instead required to provide written notification to the pass-through entity, consistent with the requirements of section 320(e)(2) of Circular A-133 (see paragraph 10.76). A subrecipient may submit a copy of the reporting package to the pass-through entity, to comply with the notification requirement.

APPENDIX A

Single Audit Act Amendments of 1996

Public Law 104-156
104th Congress

An Act

July 5, 1996
[S. 1579]

To streamline and improve the effectiveness of chapter 75 of title 31, United States Code (commonly referred to as the "Single Audit Act").

Single Audit Act
Amendments of
1996.
31 USC 7501
note.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; PURPOSES.

(a) **SHORT TITLE**—This Act may be cited as the "Single Audit Act Amendments of 1996".

(b) **PURPOSES**—The purposes of this Act are to—

- (1) promote sound financial management, including effective internal controls, with respect to Federal awards administered by non-Federal entities;
- (2) establish uniform requirements for audits of Federal awards administered by non-Federal entities;
- (3) promote the efficient and effective use of audit resources;
- (4) reduce burdens on State and local governments, Indian tribes, and nonprofit organizations; and
- (5) ensure that Federal departments and agencies, to the maximum extent practicable, rely upon and use audit work done pursuant to chapter 75 of title 31, United States Code (as amended by this Act).

SEC. 2. AMENDMENT TO TITLE 31, UNITED STATES CODE.

Chapter 75 of title 31, United States Code, is amended to read as follows:

"CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS
"Sec.

- "7501. Definitions.
"7502. Audit requirements; exemptions.
"7503. Relation to other audit requirements.
"7504. Federal agency responsibilities and relations with non-Federal entities.
"7505. Regulations.
"7506. Monitoring responsibilities of the Comptroller General.
"7507. Effective date.

"§ 7501. Definitions

"(a) As used in this chapter, the term—

- "(1) 'Comptroller General' means the Comptroller General of the United States;
- "(2) 'Director' means the Director of the Office of Management and Budget;
- "(3) 'Federal agency' has the same meaning as the term 'agency' in section 551(1) of title 5;
- "(4) "Federal awards' means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities;

“(5) ‘Federal financial assistance’ means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance, but does not include amounts received as reimbursement for services rendered to individuals in accordance with guidance issued by the Director;

“(6) ‘Federal program’ means all Federal awards to a non-Federal entity assigned a single number in the Catalog of Federal Domestic Assistance or encompassed in a group of numbers or other category as defined by the Director;

“(7) ‘generally accepted government auditing standards’ means the government auditing standards issued by the Comptroller General;

“(8) ‘independent auditor’ means—

“(A) an external State or local government auditor who meets the independence standards included in generally accepted government auditing standards; or

“(B) a public accountant who meets such independence standards;

“(9) ‘Indian tribe’ means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians;

“(10) ‘internal controls’ means a process, effected by an entity’s management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

“(A) Effectiveness and efficiency of operations.

“(B) Reliability of financial reporting.

“(C) Compliance with applicable laws and regulations;

“(11) ‘local government’ means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, any other instrumentality of local government and, in accordance with guidelines issued by the Director, a group of local governments;

“(12) ‘major program’ means a Federal program identified in accordance with risk-based criteria prescribed by the Director under this chapter, subject to the limitations described under subsection (b);

“(13) ‘non-Federal entity’ means a State, local government, or nonprofit organization;

“(14) ‘nonprofit organization’ means any corporation, trust, association, cooperative, or other organization that—

“(A) is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;

“(B) is not organized primarily for profit; and

“(C) uses net proceeds to maintain, improve, or expand the operations of the organization;

“(15) ‘pass-through entity’ means a non-Federal entity that provides Federal awards to a subrecipient to carry out a Federal program;

“(16) ‘program-specific audit’ means an audit of one Federal program;

“(17) ‘recipient’ means a non-Federal entity that receives awards directly from a Federal agency to carry out a Federal program;

“(18) ‘single audit’ means an audit, as described under section 7502(d), of a non-Federal entity that includes the entity’s financial statements and Federal awards;

“(19) ‘State’ means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe; and

“(20) ‘subrecipient’ means a non-Federal entity that receives Federal awards through another non-Federal entity to carry out a Federal program, but does not include an individual who receives financial assistance through such awards.

“(b) In prescribing risk-based program selection criteria for major programs, the Director shall not require more programs to be identified as major for a particular non-Federal entity, except as prescribed under subsection (c) or as provided under subsection (d), than would be identified if the major programs were defined as any program for which total expenditures of Federal awards by the non-Federal entity during the applicable year exceed—

“(1) the larger of \$30,000,000 or 0.15 percent of the non-Federal entity’s total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed \$10,000,000,000;

“(2) the larger of \$3,000,000, or 0.30 percent of the non-Federal entity’s total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed \$100,000,000 but are less than or equal to \$10,000,000,000; or

“(3) the larger of \$300,000, or 3 percent of such total Federal expenditures for all programs, in the case of a non-Federal entity for which such total expenditures for all programs equal or exceed \$300,000 but are less than or equal to \$100,000,000.

“(c) When the total expenditures of a non-Federal entity’s major programs are less than 50 percent of the non-Federal entity’s total expenditures of all Federal awards (or such lower percentage as specified by the Director), the auditor shall select and test additional programs as major programs as necessary to achieve audit coverage of at least 50 percent of Federal expenditures by the non-Federal entity (or such lower percentage as specified by the Director), in accordance with guidance issued by the Director.

“(d) Loan or loan guarantee programs, as specified by the Director, shall not be subject to the application of subsection (b).

“§ 7502. Audit requirements; exemptions

“(a)(1)(A) Each non-Federal entity that expends a total amount of Federal awards equal to or in excess of \$300,000 or such other amount

specified by the Director under subsection (a)(3) in any fiscal year of such non-Federal entity shall have either a single audit or a program-specific audit made for such fiscal year in accordance with the requirements of this chapter.

“(B) Each such non-Federal entity that expends Federal awards under more than one Federal program shall undergo a single audit in accordance with the requirements of subsections (b) through (i) of this section and guidance issued by the Director under section 7505.

“(C) Each such non-Federal entity that expends awards under only one Federal program and is not subject to laws, regulations, or Federal award agreements that require a financial statement audit of the non-Federal entity, may elect to have a program-specific audit conducted in accordance with applicable provisions of this section and guidance issued by the Director under section 7505.

“(2)(A) Each non-Federal entity that expends a total amount of Federal awards of less than \$300,000 or such other amount specified by the Director under subsection (a)(3) in any fiscal year of such entity, shall be exempt for such fiscal year from compliance with—

“(i) the audit requirements of this chapter; and

“(ii) any applicable requirements concerning financial audits contained in Federal statutes and regulations governing programs under which such Federal awards are provided to that non-Federal entity.

“(B) The provisions of subparagraph (A)(ii) of this paragraph shall not exempt a non-Federal entity from compliance with any provision of a Federal statute or regulation that requires such non-Federal entity to maintain records concerning Federal awards provided to such non-Federal entity or that permits a Federal agency, pass-through entity, or the Comptroller General access to such records.

“(3) Every 2 years, the Director shall review the amount for requiring audits prescribed under paragraph (1)(A) and may adjust such dollar amount consistent with the purposes of this chapter, provided the Director does not make such adjustments below \$300,000.

“(b)(1) Except as provided in paragraphs (2) and (3), audits conducted pursuant to this chapter shall be conducted annually.

“(2) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

“(3) Any nonprofit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

“(c) Each audit conducted pursuant to subsection (a) shall be conducted by an independent auditor in accordance with generally

accepted government auditing standards, except that, for the purposes of this chapter, performance audits shall not be required except as authorized by the Director.

“(d) Each single audit conducted pursuant to subsection (a) for any fiscal year shall—

“(1) cover the operations of the entire non-Federal entity; or

“(2) at the option of such non-Federal entity such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and organizational unit, which shall be considered to be a non-Federal entity.

“(e) The auditor shall—

“(1) determine whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles;

“(2) determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole;

“(3) with respect to internal controls pertaining to the compliance requirements for each major program—

“(A) obtain an understanding of such internal controls;

“(B) assess control risk; and

“(C) perform tests of controls unless the controls are deemed to be ineffective; and

“(4) determine whether the non-Federal entity has complied with the provisions of laws, regulations, and contracts or grants pertaining to Federal awards that have a direct and material effect on each major program.

“(f)(1) Each Federal agency which provides Federal awards to a recipient shall—

“(A) provide such recipient the program names (and any identifying numbers) from which such awards are derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter; and

“(B) review the audit of a recipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the recipient by the Federal agency.

“(2) Each pass-through entity shall—

“(A) provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;

“(B) monitor the subrecipient’s use of Federal awards through site visits, limited scope audits, or other means;

“(C) review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and

Audits of State and Local Governmental Units

“(D) require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the pass-through entity to have such access to the subrecipient’s records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

“(g)(1) The auditor shall report on the results of any audit conducted pursuant to this section, in accordance with guidance issued by the Director. Reports.

“(2) When reporting on any single audit, the auditor shall include a summary of the auditor’s results regarding the non-Federal entity’s financial statements, internal controls, and compliance with laws and regulations.

“(h) The non-Federal entity shall transmit the reporting package, which shall include the non-Federal entity’s financial statements, schedule of expenditures of Federal awards, corrective action plan defined under subsection (i), and auditor’s reports developed pursuant to this section, to a Federal clearinghouse designated by the Director, and make it available for public inspection within the earlier of—

“(1) 30 days after receipt of the auditor’s report; or

“(2)(A) for a transition period of at least 2 years after the effective date of the Single Audit Act Amendments of 1996, as established by the Director, 13 months after the end of the period audited; or

“(B) for fiscal years beginning after the period specified in subparagraph (A), 9 months after the end of the period audited, or within a longer time frame authorized by the Federal agency, determined under criteria issued under section 7504, when the 9-month time frame would place an undue burden on the non-Federal entity.

“(i) If an audit conducted pursuant to this section discloses any audit findings, as defined by the Director, including material noncompliance with individual compliance requirements for a major program by, or reportable conditions in the internal controls of, the non-Federal entity with respect to the matters described in subsection (e), the non-Federal entity shall submit to Federal officials designated by the Director, a plan for corrective action to eliminate such audit findings or reportable conditions or a statement describing the reasons that corrective action is not necessary. Such plan shall be consistent with the audit resolution standard promulgated by the Comptroller General (as part of the standards for internal controls in the Federal Government) pursuant to section 3512(c).

“(j) The Director may authorize pilot projects to test alternative methods of achieving the purposes of this chapter. Such pilot projects may begin only after consultation with the Chair and Ranking Minority Member of the Committee on Governmental Affairs of the Senate and the Chair and Ranking Minority Member of the Committee on Government Reform and Oversight of the House of Representatives.

§ 7503. Relation to other audit requirements

“(a) An audit conducted in accordance with this chapter shall be in lieu of any financial audit of Federal awards which a non-Federal entity is required to undergo under any other Federal law or regulation. To the extent that such audit provides a Federal agency with the information it requires to carry out its responsibilities under Federal

law or regulation, a Federal agency shall rely upon and use that information.

“(b) Notwithstanding subsection (a), a Federal agency may conduct or arrange for additional audits which are necessary to carry out its responsibilities under Federal law or regulation. The provisions of this chapter do not authorize any non-Federal entity (or subrecipient thereof) to constrain, in any manner, such agency from carrying out or arranging for such additional audits, except that the Federal agency shall plan such audits to not be duplicative of other audits of Federal awards.

“(c) The provisions of this chapter do not limit the authority of Federal agencies to conduct, or arrange for the conduct of, audits and evaluations of Federal awards, nor limit the authority of any Federal agency Inspector General or other Federal official.

“(d) Subsection (a) shall apply to a non-Federal entity which undergoes an audit in accordance with this chapter even though it is not required by section 7502(a) to have such an audit.

“(e) A Federal agency that provides Federal awards and conducts or arranges for audits of non-Federal entities receiving such awards that are in addition to the audits of non-Federal entities conducted pursuant to this chapter shall, consistent with other applicable law, arrange for funding the full cost of such additional audits. Any such additional audits shall be coordinated with the Federal agency determined under criteria issued under section 7504 to preclude duplication of the audits conducted pursuant to this chapter or other additional audits.

“(f) Upon request by a Federal agency or the Comptroller General, any independent auditor conducting an audit pursuant to this chapter shall make the auditor's working papers available to the Federal agency or the Comptroller General as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this chapter. Such access to auditor's working papers shall include the right to obtain copies.

“§ 7504. Federal agency responsibilities and relations with non-Federal entities

“(a) Each Federal agency shall, in accordance with guidance issued by the Director under section 7505, with regard to Federal awards provided by the agency—

“(1) monitor non-Federal entity use of Federal awards, and

“(2) assess the quality of audits conducted under this chapter for audits of entities for which the agency is the single Federal agency determined under subsection (b).

“(b) Each non-Federal entity shall have a single Federal agency, determined in accordance with criteria established by the Director, to provide the non-Federal entity with technical assistance and assist with implementation of this chapter.

“(c) The Director shall designate a Federal clearinghouse to—

“(1) receive copies of all reporting packages developed in accordance with this chapter;

“(2) identify recipients that expend \$300,000 or more in Federal awards or such other amount specified by the Director under section 7502(a)(3) during the recipient's fiscal year but did not undergo an audit in accordance with this chapter; and

“(3) perform analyses to assist the Director in carrying out responsibilities under this chapter.

“§ 7505. Regulations

“(a) The Director, after consultation with the Comptroller General, and appropriate officials from Federal, State, and local governments and nonprofit organizations shall prescribe guidance to implement this chapter. Each Federal agency shall promulgate such amendments to its regulations as may be necessary to conform such regulations to the requirements of this chapter and of such guidance.

“(b)(1) The guidance prescribed pursuant to subsection (a) shall include criteria for determining the appropriate charges to Federal awards for the cost of audits. Such criteria shall prohibit a non-Federal entity from charging to any Federal awards—

“(A) the cost of any audit which is—

“(i) not conducted in accordance with this chapter; or

“(ii) conducted in accordance with this chapter when expenditures of Federal awards are less than amounts cited in section 7502(a)(1)(A) or specified by the Director under section 7502(a)(3), except that the Director may allow the cost of limited scope audits to monitor subrecipients in accordance with section 7502(f)(2)(B); and

“(B) more than a reasonably proportionate share of the cost of any such audit that is conducted in accordance with this chapter.

“(2) The criteria prescribed pursuant to paragraph (1) shall not, in the absence of documentation demonstrating a higher actual cost, permit the percentage of the cost of audits performed pursuant to this chapter charged to Federal awards, to exceed the ratio of total Federal awards expended by such non-Federal entity during the applicable fiscal year or years, to such non-Federal entity’s total expenditures during such fiscal year or years.

“(c) Such guidance shall include such provisions as may be necessary to ensure that small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the audit requirements of this chapter.

“§ 7506. Monitoring responsibilities of the Comptroller General

“(a) The Comptroller General shall review provisions requiring financial audits of non-Federal entities that receive Federal awards that are contained in bills and resolutions reported by the committees of the Senate and the House of Representatives.

“(b) If the Comptroller General determines that a bill or resolution contains provisions that are inconsistent with the requirements of this chapter, the Comptroller General shall, at the earliest practicable date, notify in writing—

“(1) the committee that reported such bill or resolution; and

“(2)(A) the Committee on Governmental Affairs of the Senate (in the case of a bill or resolution reported by a committee of the Senate); or

“(B) the Committee on Government Reform and Oversight of the House of Representatives (in the case of a bill or resolution reported by a committee of the House of Representatives).

“§ 7507. Effective date

“This chapter shall apply to any non-Federal entity with respect to any of its fiscal years which begin after June 30, 1996.”.

31 USC 7501
note.

SEC. 3. TRANSITIONAL APPLICATION

Subject to section 7507 of title 31, United States Code (as amended by section 2 of this Act) the provisions of chapter 75 of such title (before amendment by section 2 of this Act) shall continue to apply to any State or local government with respect to any of its fiscal years beginning before July 1, 1996.

Approved July 5, 1996.

LEGISLATIVE HISTORY—S. 1579 (H.R. 3184):

HOUSE REPORTS: No. 104–607 accompanying H.R. 3184 (Comm. on Government Reform and Oversight).

SENATE REPORTS: No. 104–266 (Comm. On Governmental Affairs).

CONGRESSIONAL RECORD, Vol. 142 (1996):

June 14, considered and passed Senate.

June 18, considered and passed House.

WEEKLY COMPILATION OF PRESIDENTIAL DOCUMENTS, Vol. 32 (1996):

July 5, Presidential statement.

APPENDIX B

OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations

Franklin D. Raines,
Director

1. OMB rescinds Circular A-128 July 30, 1997
2. OMB revises Circular A-133 to read as follows:

[Circular No. A-133—Revised]

To the Heads of Executive Departments and Establishments

SUBJECT: Audits of States, Local Governments, and Non-Profit Organizations.

1. *Purpose.* This Circular is issued pursuant to the Single Audit Act of 1984, P.L. 98-502, and the Single Audit Act Amendments of 1996, P.L. 104-156. It sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of States, local governments, and non-profit organizations expending Federal awards.

2. *Authority.* Circular A-133 is issued under the authority of sections 503, 1111, and 7501 *et seq.* of title 31, United States Code, and Executive Orders 8248 and 11541.

3. *Rescission and Supersession.* This Circular rescinds Circular A-128, "Audits of State and Local Governments," issued April 12, 1985, and supersedes the prior Circular A-133, "Audits of Institutions of Higher Education and Other Non-Profit Institutions," issued April 22, 1996. For effective dates, see paragraph 10.

4. *Policy.* Except as provided herein, the standards set forth in this Circular shall be applied by all Federal agencies. If any statute specifically prescribes policies or specific requirements that differ from the standards provided herein, the provisions of the subsequent statute shall govern.

Federal agencies shall apply the provisions of the sections of this Circular to non-Federal entities, whether they are recipients expending Federal awards received directly from Federal awarding agencies, or are subrecipients expending Federal awards received from a pass-through entity (a recipient or another subrecipient).

This Circular does not apply to non-U.S. based entities expending Federal awards received either directly as a recipient or indirectly as a subrecipient.

5. *Definitions.* The definitions of key terms used in this Circular are contained in § __.105 in the Attachment to this Circular.

6. *Required Action.* The specific requirements and responsibilities of Federal agencies and non-Federal entities are set forth in the Attachment to this

Circular. Federal agencies making awards to non-Federal entities, either directly or indirectly, shall adopt the language in the Circular in codified regulations as provided in Section 10 (below), unless different provisions are required by Federal statute or are approved by the Office of Management and Budget (OMB).

7. OMB Responsibilities. OMB will review Federal agency regulations and implementation of this Circular, and will provide interpretations of policy requirements and assistance to ensure uniform, effective and efficient implementation.

8. Information Contact. Further information concerning Circular A-133 may be obtained by contacting the Financial Standards and Reporting Branch, Office of Federal Financial Management, Office of Management and Budget, Washington, DC 20503, telephone (202) 395-3993.

9. Review Date. This Circular will have a policy review three years from the date of issuance.

10. Effective Dates. The standards set forth in §___400 of the Attachment to this Circular, which apply directly to Federal agencies, shall be effective July 1, 1996, and shall apply to audits of fiscal years beginning after June 30, 1996, except as otherwise specified in §___400(a).

The standards set forth in this Circular that Federal agencies shall apply to non-Federal entities shall be adopted by Federal agencies in codified regulations not later than 60 days after publication of this final revision in the **Federal Register**, so that they will apply to audits of fiscal years beginning after June 30, 1996, with the exception that §___305(b) of the Attachment applies to audits of fiscal years beginning after June 30, 1998. The requirements of Circular A-128, although the Circular is rescinded, and the 1990 version of Circular A-133 remain in effect for audits of fiscal years beginning on or before June 30, 1996.

Franklin D. Raines,
Director.

Attachment

PART __—AUDITS OF STATES, LOCAL GOVERNMENTS, AND NON-PROFIT ORGANIZATIONS**Subpart A—General**

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Appendix A to Part __—Data Collection Form (Form SF-SAC)**Appendix B to Part __—Circular A-133 Compliance Supplement****Subpart A—General**

§ __.100 Purpose.

This part sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of non-Federal entities expending Federal awards.

§ __.105 Definitions.

Auditee means any non-Federal entity that expends Federal awards which must be audited under this part.

Auditor means an auditor, that is a public accountant or a Federal, State or local government audit organization, which meets the general standards specified in generally accepted government auditing standards (GAGAS). The term auditor does not include internal auditors of non-profit organizations.

Audit finding means deficiencies which the auditor is required by § __.510(a) to report in the schedule of findings and questioned costs.

CFDA number means the number assigned to a Federal program in the *Catalog of Federal Domestic Assistance (CFDA)*.

Cluster of programs means a grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development (R&D), student financial aid (SFA), and other clusters. "Other clusters" are as defined by the Office of Management and Budget (OMB) in the compliance supplement or as designated by a State for Federal awards the State provides to its subrecipients that meet the definition of a cluster of programs. When designating an "other cluster," a State shall identify the Federal awards included in the cluster and advise the subrecipients of compliance requirements applicable to the cluster, consistent with § __.400(d)(1) and § __.400(d)(2), respectively. A cluster of programs shall be considered as one program for determining major programs, as described in § __.520, and, with the exception of R&D as described in § __.200(c), whether a program-specific audit may be elected.

Cognizant agency for audit means the Federal agency designated to carry out the responsibilities described in § __.400(a).

Compliance supplement refers to the *Circular A-133 Compliance Supplement*, included as Appendix B to Circular A-133, or such documents as OMB or its designee may issue to replace it. This document is available from the Government Printing Office, Superintendent of Documents, Washington, DC 20402-9325.

Corrective action means action taken by the auditee that:

- (1) Corrects identified deficiencies;
- (2) Produces recommended improvements; or
- (3) Demonstrates that audit findings are either invalid or do not warrant auditee action.

Federal agency has the same meaning as the term *agency* in Section 551(1) of title 5, United States Code.

Federal award means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors. Any audits of such vendors shall be covered by the terms and conditions of the contract. Contracts to operate Federal Government owned, contractor operated facilities (GOCOs) are excluded from the requirements of this part.

Federal awarding agency means the Federal agency that provides an award directly to the recipient.

Federal financial assistance means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance, but does not include amounts received as reimbursement for services rendered to individuals as described in §__.205(h) and §__.205(i).

Federal program means:

- (1) All Federal awards to a non-Federal entity assigned a single number in the CFDA.
- (2) When no CFDA number is assigned, all Federal awards from the same agency made for the same purpose should be combined and considered one program.
- (3) Notwithstanding paragraphs (1) and (2) of this definition, a cluster of programs. The types of clusters of programs are:
 - (i) Research and development (R&D);
 - (ii) Student financial aid (SFA); and
 - (iii) "Other clusters," as described in the definition of cluster of programs in this section.

GAGAS means generally accepted government auditing standards issued by the Comptroller General of the United States, which are applicable to financial audits.

Generally accepted accounting principles has the meaning specified in generally accepted auditing standards issued by the American Institute of Certified Public Accountants (AICPA).

Indian tribe means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

Internal control means a process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- (1) Effectiveness and efficiency of operations;
- (2) Reliability of financial reporting; and
- (3) Compliance with applicable laws and regulations.

Internal control pertaining to the compliance requirements for Federal programs (Internal control over Federal programs) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for Federal programs:

- (1) Transactions are properly recorded and accounted for to:
 - (i) Permit the preparation of reliable financial statements and Federal reports;

- (ii) Maintain accountability over assets; and
 - (iii) Demonstrate compliance with laws, regulations, and other compliance requirements;
- (2) Transactions are executed in compliance with:
- (i) Laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on a Federal program; and
 - (ii) Any other laws and regulations that are identified in the compliance supplement; and
- (3) Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Loan means a Federal loan or loan guarantee received or administered by a non-Federal entity.

Local government means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

Major program means a Federal program determined by the auditor to be a major program in accordance with §___.520 or a program identified as a major program by a Federal agency or pass-through entity in accordance with §___.215(c).

Management decision means the evaluation by the Federal awarding agency or pass-through entity of the audit findings and corrective action plan and the issuance of a written decision as to what corrective action is necessary.

Non-Federal entity means a State, local government, or non-profit organization.

Non-profit organization means:

- (1) any corporation, trust, association, cooperative, or other organization that:
 - (i) Is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;
 - (ii) Is not organized primarily for profit; and
 - (iii) Uses its net proceeds to maintain, improve, or expand its operations; and
- (2) The term *non-profit organization* includes non-profit institutions of higher education and hospitals.

OMB means the Executive Office of the President, Office of Management and Budget.

Oversight agency for audit means the Federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit. When there is no direct funding, the Federal agency with the predominant indirect funding shall assume the oversight responsibilities. The duties of the oversight agency for audit are described in §___.400(b).

Pass-through entity means a non-Federal entity that provides a Federal award to a subrecipient to carry out a Federal program.

Program-specific audit means an audit of one Federal program as provided for in § __.200(c) and § __.235.

Questioned cost means a cost that is questioned by the auditor because of an audit finding:

- (1) Which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of Federal funds, including funds used to match Federal funds;
- (2) Where the costs, at the time of the audit, are not supported by adequate documentation; or
- (3) Where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

Recipient means a non-Federal entity that expends Federal awards received directly from a Federal awarding agency to carry out a Federal program.

Research and development (R&D) means all research activities, both basic and applied, and all development activities that are performed by a non-Federal entity. *Research* is defined as a systematic study directed toward fuller scientific knowledge or understanding of the subject studied. The term research also includes activities involving the training of individuals in research techniques where such activities utilize the same facilities as other research and development activities and where such activities are not included in the instruction function. *Development* is the systematic use of knowledge and understanding gained from research directed toward the production of useful materials, devices, systems, or methods, including design and development of prototypes and processes.

Single audit means an audit which includes both the entity's financial statements and the Federal awards as described in § __.500.

State means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe as defined in this section.

Student Financial Aid (SFA) includes those programs of general student assistance, such as those authorized by Title IV of the Higher Education Act of 1965, as amended, (20 U.S.C. 1070 *et seq.*) which is administered by the U.S. Department of Education, and similar programs provided by other Federal agencies. It does not include programs which provide fellowships or similar Federal awards to students on a competitive basis, or for specified studies or research.

Subrecipient means a non-Federal entity that expends Federal awards received from a pass-through entity to carry out a Federal program, but does not include an individual that is a beneficiary of such a program. A subrecipient may also be a recipient of other Federal awards directly from a Federal awarding agency. Guidance on distinguishing between a subrecipient and a vendor is provided in § __.210.

Types of compliance requirements refers to the types of compliance requirements listed in the compliance supplement. Examples include: activities allowed or unallowed; allowable costs/cost principles; cash management; eligibility; matching, level of effort, earmarking; and, reporting.

Vendor means a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a Federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the Federal program. Additional guidance on distinguishing between a subrecipient and a vendor is provided in § ___.210.

Subpart B—Audits

§ ___.200 Audit requirements.

(a) *Audit required.* Non-Federal entities that expend \$300,000 or more in a year in Federal awards shall have a single or program-specific audit conducted for that year in accordance with the provisions of this part. Guidance on determining Federal awards expended is provided in § ___.205.

(b) *Single audit.* Non-Federal entities that expend \$300,000 or more in a year in Federal awards shall have a single audit conducted in accordance with § ___.500 except when they elect to have a program-specific audit conducted in accordance with paragraph (c) of this section.

(c) *Program-specific audit election.* When an auditee expends Federal awards under only one Federal program (excluding R&D) and the Federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit conducted in accordance with § ___.235. A program-specific audit may not be elected for R&D unless all of the Federal awards expended were received from the same Federal agency, or the same Federal agency and the same pass-through entity, and that Federal agency, or pass-through entity in the case of a subrecipient, approves in advance a program-specific audit.

(d) *Exemption when Federal awards expended are less than \$300,000.* Non-Federal entities that expend less than \$300,000 a year in Federal awards are exempt from Federal audit requirements for that year, except as noted in § ___.215(a), but records must be available for review or audit by appropriate officials of the Federal agency, pass-through entity, and General Accounting Office (GAO).

(e) *Federally Funded Research and Development Centers (FFRDC).* Management of an auditee that owns or operates a FFRDC may elect to treat the FFRDC as a separate entity for purposes of this part.

§ ___.205 Basis for determining Federal awards expended.

(a) *Determining Federal awards expended.* The determination of when an award is expended should be based on when the activity related to the award occurs. Generally, the activity pertains to events that require the non-Federal entity to comply with laws, regulations, and the provisions of contracts or grant agreements, such as: expenditure/expense transactions associated with grants, cost-reimbursement contracts, cooperative agreements, and direct appropriations; the disbursement of funds passed through to subrecipients; the use of loan proceeds under loan and loan guarantee programs; the receipt of property; the receipt of surplus property; the receipt or use of program income; the distribution or consumption of food commodities; the disbursement of amounts entitling the non-Federal entity to an interest subsidy; and, the period when insurance is in force.

(b) *Loan and loan guarantees (loans).* Since the Federal Government is at risk for loans until the debt is repaid, the following guidelines shall be used to

calculate the value of Federal awards expended under loan programs, except as noted in paragraphs (c) and (d) of this section:

- (1) Value of new loans made or received during the fiscal year; plus
- (2) Balance of loans from previous years for which the Federal Government imposes continuing compliance requirements; plus
- (3) Any interest subsidy, cash, or administrative cost allowance received.

(c) *Loan and loan guarantees (loans) at institutions of higher education.* When loans are made to students of an institution of higher education but the institution does not make the loans, then only the value of loans made during the year shall be considered Federal awards expended in that year. The balance of loans for previous years is not included as Federal awards expended because the lender accounts for the prior balances.

(d) *Prior loan and loan guarantees (loans).* Loans, the proceeds of which were received and expended in prior-years, are not considered Federal awards expended under this part when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

(e) *Endowment funds.* The cumulative balance of Federal awards for endowment funds which are federally restricted are considered awards expended in each year in which the funds are still restricted.

(f) *Free rent.* Free rent received by itself is not considered a Federal award expended under this part. However, free rent received as part of an award to carry out a Federal program shall be included in determining Federal awards expended and subject to audit under this part.

(g) *Valuing non-cash assistance.* Federal non-cash assistance, such as free rent, food stamps, food commodities, donated property, or donated surplus property, shall be valued at fair market value at the time of receipt or the assessed value provided by the Federal agency.

(h) *Medicare.* Medicare payments to a non-Federal entity for providing patient care services to Medicare eligible individuals are not considered Federal awards expended under this part.

(i) *Medicaid.* Medicaid payments to a subrecipient for providing patient care services to Medicaid eligible individuals are not considered Federal awards expended under this part unless a State requires the funds to be treated as Federal awards expended because reimbursement is on a cost-reimbursement basis.

(j) *Certain loans provided by the National Credit Union Administration.* For purposes of this part, loans made from the National Credit Union Share Insurance Fund and the Central Liquidity Facility that are funded by contributions from insured institutions are not considered Federal awards expended.

§ __.210 Subrecipient and vendor determinations.

(a) *General.* An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient would be subject to audit under this part. The payments received for goods or services provided as a vendor would not be considered Federal awards. The guidance in paragraphs (b) and (c) of this section should be considered in determining whether payments constitute a Federal award or a payment for goods and services.

(b) *Federal award.* Characteristics indicative of a Federal award received by a subrecipient are when the organization:

- (1) Determines who is eligible to receive what Federal financial assistance;
- (2) Has its performance measured against whether the objectives of the Federal program are met;
- (3) Has responsibility for programmatic decision making;
- (4) Has responsibility for adherence to applicable Federal program compliance requirements; and
- (5) Uses the Federal funds to carry out a program of the organization as compared to providing goods or services for a program of the pass-through entity.

(c) *Payment for goods and services.* Characteristics indicative of a payment for goods and services received by a vendor are when the organization:

- (1) Provides the goods and services within normal business operations;
- (2) Provides similar goods or services to many different purchasers;
- (3) Operates in a competitive environment;
- (4) Provides goods or services that are ancillary to the operation of the Federal program; and
- (5) Is not subject to compliance requirements of the Federal program.

(d) *Use of judgment in making determination.* There may be unusual circumstances or exceptions to the listed characteristics. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present and judgment should be used in determining whether an entity is a subrecipient or vendor.

(e) *For-profit subrecipient.* Since this part does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. The contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for Federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits.

(f) *Compliance responsibility for vendors.* In most cases, the auditee's compliance responsibility for vendors is only to ensure that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. Program compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions which are structured such that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine program compliance. Also, when these vendor transactions relate to a major program, the scope of the audit shall include determining whether these transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements.

§ __.215 Relation to other audit requirements.

(a) *Audit under this part in lieu of other audits.* An audit made in accordance with this part shall be in lieu of any financial audit required under individual

Federal awards. To the extent this audit meets a Federal agency's needs, it shall rely upon and use such audits. The provisions of this part neither limit the authority of Federal agencies, including their Inspectors General, or GAO to conduct or arrange for additional audits (e.g., financial audits, performance audits, evaluations, inspections, or reviews) nor authorize any auditee to constrain Federal agencies from carrying out additional audits. Any additional audits shall be planned and performed in such a way as to build upon work performed by other auditors.

(b) *Federal agency to pay for additional audits.* A Federal agency that conducts or contracts for additional audits shall, consistent with other applicable laws and regulations, arrange for funding the full cost of such additional audits.

(c) *Request for a program to be audited as a major program.* A Federal agency may request an auditee to have a particular Federal program audited as a major program in lieu of the Federal agency conducting or arranging for the additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such request by informing the Federal agency whether the program would otherwise be audited as a major program using the risk-based audit approach described in § __.520 and, if not, the estimated incremental cost. The Federal agency shall then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon this Federal agency request, and the Federal agency agrees to pay the full incremental costs, then the auditee shall have the program audited as a major program. A pass-through entity may use the provisions of this paragraph for a subrecipient.

§ __.220 Frequency of audits.

Except for the provisions for biennial audits provided in paragraphs (a) and (b) of this section, audits required by this part shall be performed annually. Any biennial audit shall cover both years within the biennial period.

- (a) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this part biennially. This requirement must still be in effect for the biennial period under audit.
- (b) Any non-profit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this part biennially.

§ __.225 Sanctions.

No audit costs may be charged to Federal awards when audits required by this part have not been made or have been made but not in accordance with this part. In cases of continued inability or unwillingness to have an audit conducted in accordance with this part, Federal agencies and pass-through entities shall take appropriate action using sanctions such as:

- (a) Withholding a percentage of Federal awards until the audit is completed satisfactorily;
- (b) Withholding or disallowing overhead costs;
- (c) Suspending Federal awards until the audit is conducted; or
- (d) Terminating the Federal award.

§ __.230 Audit costs.

(a) *Allowable costs.* Unless prohibited by law, the cost of audits made in accordance with the provisions of this part are allowable charges to Federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB cost principles circulars, the Federal Acquisition Regulation (FAR) (48 CFR parts 30 and 31), or other applicable cost principles or regulations.

(b) *Unallowable costs.* A non-Federal entity shall not charge the following to a Federal award:

- (1) The cost of any audit under the Single Audit Act Amendments of 1996 (31 U.S.C. 7501 *et seq.*) not conducted in accordance with this part.
- (2) The cost of auditing a non-Federal entity which has Federal awards expended of less than \$300,000 per year and is thereby exempted under § __.200(d) from having an audit conducted under this part. However, this does not prohibit a pass-through entity from charging Federal awards for the cost of limited scope audits to monitor its subrecipients in accordance with § __.400(d)(3), provided the subrecipient does not have a single audit. For purposes of this part, limited scope audits only include agreed-upon procedures engagements conducted in accordance with either the AICPA's generally accepted auditing standards or attestation standards, that are paid for and arranged by a pass-through entity and address only one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching, level of effort, earmarking; and, reporting.

§ __.235 Program-specific audits.

(a) *Program-specific audit guide available.* In many cases, a program-specific audit guide will be available to provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. The auditor should contact the Office of Inspector General of the Federal agency to determine whether such a guide is available. When a current program-specific audit guide is available, the auditor shall follow GAGAS and the guide when performing a program-specific audit.

(b) *Program-specific audit guide not available.* (1) When a program-specific audit guide is not available, the auditee and auditor shall have basically the same responsibilities for the Federal program as they would have for an audit of a major program in a single audit.

- (2) The auditee shall prepare the financial statement(s) for the Federal program that includes, at a minimum, a schedule of expenditures of Federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule, a summary schedule of prior audit findings consistent with the requirements of § __.315(b), and a corrective action plan consistent with the requirements of § __.315(c).
- (3) The auditor shall:
 - (i) Perform an audit of the financial statement(s) for the Federal program in accordance with GAGAS;

- (ii) Obtain an understanding of internal control and perform tests of internal control over the Federal program consistent with the requirements of § __.500(c) for a major program;
 - (iii) Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the Federal program consistent with the requirements of § __.500(d) for a major program; and
 - (iv) Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of § __.500(e).
- (4) The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:
- (i) An opinion (or disclaimer of opinion) as to whether the financial statement(s) of the Federal program is presented fairly in all material respects in conformity with the stated accounting policies;
 - (ii) A report on internal control related to the Federal program, which shall describe the scope of testing of internal control and the results of the tests;
 - (iii) A report on compliance which includes an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on the Federal program; and
 - (iv) A schedule of findings and questioned costs for the Federal program that includes a summary of the auditor's results relative to the Federal program in a format consistent with § __.505(d)(1) and findings and questioned costs consistent with the requirements of § __.505(d)(3).

(c) *Report submission for program-specific audits.* (1) The audit shall be completed and the reporting required by paragraph (c)(2) or (c)(3) of this section submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the Federal agency that provided the funding or a different period is specified in a program-specific audit guide. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the required reporting shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period, unless a different period is specified in a program-specific audit guide.) Unless restricted by law or regulation, the auditee shall make report copies available for public inspection.

- (2) When a program-specific audit guide is available, the auditee shall submit to the Federal clearinghouse designated by OMB the data

collection form prepared in accordance with § __.320(b), as applicable to a program-specific audit, and the reporting required by the program-specific audit guide to be retained as an archival copy. Also, the auditee shall submit to the Federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

- (3) When a program-specific audit guide is not available, the reporting package for a program-specific audit shall consist of the financial statement(s) of the Federal program, a summary schedule of prior audit findings, and a corrective action plan as described in paragraph (b)(2) of this section, and the auditor's report(s) described in paragraph (b)(4) of this section. The data collection form prepared in accordance with § __.320(b), as applicable to a program-specific audit, and one copy of this reporting package shall be submitted to the Federal clearinghouse designated by OMB to be retained as an archival copy. Also, when the schedule of findings and questioned costs disclosed audit findings or the summary schedule of prior audit findings reported the status of any audit findings, the auditee shall submit one copy of the reporting package to the Federal clearinghouse on behalf of the Federal awarding agency, or directly to the pass-through entity in the case of a subrecipient. Instead of submitting the reporting package to the pass-through entity, when a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient shall provide written notification to the pass-through entity, consistent with the requirements of § __.320(e)(2). A subrecipient may submit a copy of the reporting package to the pass-through entity to comply with this notification requirement.

(d) *Other sections of this part may apply.* Program-specific audits are subject to § __.100 through § __.215(b), § __.220 through § __.230, § __.300 through § __.305, § __.315, § __.320(f) through § __.320(j), § __.400 through § __.405, § __.510 through § __.515, and other referenced provisions of this part unless contrary to the provisions of this section, a program-specific audit guide, or program laws and regulations.

Subpart C—Auditees

§ __.300 Auditee responsibilities.

The auditee shall:

- (a) Identify, in its accounts, all Federal awards received and expended and the Federal programs under which they were received. Federal program and award identification shall include, as applicable, the CFDA title and number, award number and year, name of the Federal agency, and name of the pass-through entity.
- (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs.
- (c) Comply with laws, regulations, and the provisions of contracts or grant agreements related to each of its Federal programs.

- (d) Prepare appropriate financial statements, including the schedule of expenditures of Federal awards in accordance with §___.310.
- (e) Ensure that the audits required by this part are properly performed and submitted when due. When extensions to the report submission due date required by §___.320(a) are granted by the cognizant or oversight agency for audit, promptly notify the Federal clearing-house designated by OMB and each pass-through entity providing Federal awards of the extension.
- (f) Follow up and take corrective action on audit findings, including preparation of a summary schedule of prior audit findings and a corrective action plan in accordance with §___.315(b) and §___.315(c), respectively.

§___.305 Auditor selection.

(a) *Auditor procurement.* In procuring audit services, auditees shall follow the procurement standards prescribed by the Grants Management Common Rule (hereinafter referred to as the "A-102 Common Rule") published March 11, 1988 and amended April 19, 1995 [insert appropriate CFR citation], Circular A-110, "Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations," or the FAR (48 CFR part 42), as applicable (OMB Circulars are available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503). Whenever possible, auditees shall make positive efforts to utilize small businesses, minority-owned firms, and women's business enterprises, in procuring audit services as stated in the A-102 Common Rule, OMB Circular A-110, or the FAR (48 CFR part 42), as applicable. In requesting proposals for audit services, the objectives and scope of the audit should be made clear. Factors to be considered in evaluating each proposal for audit services include the responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality control reviews, and price.

(b) *Restriction on auditor preparing indirect cost proposals.* An auditor who prepares the indirect cost proposal or cost allocation plan may not also be selected to perform the audit required by this part when the indirect costs recovered by the auditee during the prior year exceeded \$1 million. This restriction applies to the base year used in the preparation of the indirect cost proposal or cost allocation plan and any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. To minimize any disruption in existing contracts for audit services, this paragraph applies to audits of fiscal years beginning after June 30, 1998.

(c) *Use of Federal auditors.* Federal auditors may perform all or part of the work required under this part if they comply fully with the requirements of this part.

§___.310 Financial statements.

(a) *Financial statements.* The auditee shall prepare financial statements that reflect its financial position, results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements shall be for the same organizational unit and fiscal year that is chosen to meet the requirements of this part. However, organization-wide financial

statements may also include departments, agencies, and other organizational units that have separate audits in accordance with §___500(a) and prepare separate financial statements.

(b) *Schedule of expenditures of Federal awards.* The auditee shall also prepare a schedule of expenditures of Federal awards for the period covered by the auditee's financial statements. While not required, the auditee may choose to provide information requested by Federal awarding agencies and pass-through entities to make the schedule easier to use. For example, when a Federal program has multiple award years, the auditee may list the amount of Federal awards expended for each award year separately. At a minimum, the schedule shall:

- (1) List individual Federal programs by Federal agency. For Federal programs included in a cluster of programs, list individual Federal programs within a cluster of programs. For R&D, total Federal awards expended shall be shown either by individual award or by Federal agency and major subdivision within the Federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services.
- (2) For Federal awards received as a subrecipient, the name of the pass-through entity and identifying number assigned by the pass-through entity shall be included.
- (3) Provide total Federal awards expended for each individual Federal program and the CFDA number or other identifying number when the CFDA information is not available.
- (4) Include notes that describe the significant accounting policies used in preparing the schedule.
- (5) To the extent practical, pass-through entities should identify in the schedule the total amount provided to subrecipients from each Federal program.
- (6) Include, in either the schedule or a note to the schedule, the value of the Federal awards expended in the form of non-cash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end. While not required, it is preferable to present this information in the schedule.

§___315 **Audit findings follow-up.**

(a) *General.* The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee shall prepare a summary schedule of prior audit findings. The auditee shall also prepare a corrective action plan for current year audit findings. The summary schedule of prior audit findings and the corrective action plan shall include the reference numbers the auditor assigns to audit findings under §___510(c). Since the summary schedule may include audit findings from multiple years, it shall include the fiscal year in which the finding initially occurred.

(b) *Summary schedule of prior audit findings.* The summary schedule of prior audit findings shall report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to Federal awards. The summary schedule shall also include audit findings reported in the prior audit's summary schedule of prior audit findings except audit findings listed as corrected in accordance with paragraph (b)(1) of this section, or no longer valid or not warranting further action in accordance with paragraph (b)(4) of this section.

- (1) When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.
- (2) When audit findings were not corrected or were only partially corrected, the summary schedule shall describe the planned corrective action as well as any partial corrective action taken.
- (3) When corrective action taken is significantly different from corrective action previously reported in a corrective action plan or in the Federal agency's or pass-through entity's management decision, the summary schedule shall provide an explanation.
- (4) When the auditee believes the audit findings are no longer valid or do not warrant further action, the reasons for this position shall be described in the summary schedule. A valid reason for considering an audit finding as not warranting further action is that all of the following have occurred:
 - (i) Two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse;
 - (ii) The Federal agency or pass-through entity is not currently following up with the auditee on the audit finding; and
 - (iii) A management decision was not issued.

(c) *Corrective action plan.* At the completion of the audit, the auditee shall prepare a corrective action plan to address each audit finding included in the current year auditor's reports. The corrective action plan shall provide the name(s) of the contact person(s) responsible for corrective action, the corrective action planned, and the anticipated completion date. If the auditee does not agree with the audit findings or believes corrective action is not required, then the corrective action plan shall include an explanation and specific reasons.

§ __.320 Report submission.

(a) *General.* The audit shall be completed and the data collection form described in paragraph (b) of this section and reporting package described in paragraph (c) of this section shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the data collection form and reporting package shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period.) Unless restricted by law or regulation, the auditee shall make copies available for public inspection.

(b) *Data Collection.* (1) The auditee shall submit a data collection form which states whether the audit was completed in accordance with this part and provides information about the auditee, its Federal programs, and the results of the audit. The form shall be approved by OMB, available from the Federal clearinghouse designated by OMB, and include data elements similar to those presented in this paragraph. A senior level representative of the auditee (e.g., State controller, director of finance, chief executive officer, or chief financial officer) shall sign a statement to be included as part of the form certifying that: the auditee complied with the requirements of this part, the form was prepared in accordance with this part (and the instructions accompanying the form), and the information included in the form, in its entirety, are accurate and complete.

- (2) The data collection form shall include the following data elements:
- (i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - (ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.
 - (iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee.
 - (iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.
 - (v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - (vi) A list of the Federal awarding agencies which will receive a copy of the reporting package pursuant to § __.320(d)(2).
 - (vii) A yes or no statement as to whether the auditee qualified as a low-risk auditee under § __.530.
 - (viii) The dollar threshold used to distinguish between Type A and Type B programs as defined in § __.520(b).
 - (ix) The *Catalog of Federal Domestic Assistance* (CFDA) number for each Federal program, as applicable.
 - (x) The name of each Federal program and identification of each major program. Individual programs within a cluster of programs should be listed in the same level of detail as they are listed in the schedule of expenditures of Federal awards.
 - (xi) The amount of expenditures in the schedule of expenditures of Federal awards associated with each Federal program.
 - (xii) For each Federal program, a yes or no statement as to whether there are audit findings in each of the following types of compliance requirements and the total amount of any questioned costs:
 - (A) Activities allowed or unallowed.
 - (B) Allowable costs/cost principles.
 - (C) Cash management.
 - (D) Davis-Bacon Act.
 - (E) Eligibility.
 - (F) Equipment and real property management.
 - (G) Matching, level of effort, earmarking.
 - (H) Period of availability of Federal funds.
 - (I) Procurement and suspension and debarment.
 - (J) Program income.
 - (K) Real property acquisition and relocation assistance.

- (L) Reporting.
- (M) Subrecipient monitoring.
- (N) Special tests and provisions.

(xiii) Auditee Name, Employer Identification Number(s), Name and Title of Certifying Official, Telephone Number, Signature, and Date.

(xiv) Auditor Name, Name and Title of Contact Person, Auditor Address, Auditor Telephone Number, Signature, and Date.

(xv) Whether the auditee has either a cognizant or oversight agency for audit.

(xvi) The name of the cognizant or oversight agency for audit determined in accordance with §___.400(a) and §___.400(b), respectively.

- (3) Using the information included in the reporting package described in paragraph (c) of this section, the auditor shall complete the applicable sections of the form. The auditor shall sign a statement to be included as part of the data collection form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package described in paragraph (c) of this section, and that the content of the form is limited to the data elements prescribed by OMB.

(c) *Reporting package.* The reporting package shall include the:

- (1) Financial statements and schedule of expenditures of Federal awards discussed in §___.310(a) and §___.310(b), respectively;
- (2) Summary schedule of prior audit findings discussed in §___.315(b);
- (3) Auditor's report(s) discussed in §___.505; and
- (4) Corrective action plan discussed in §___.315(c).

(d) *Submission to clearinghouse.* All auditees shall submit to the Federal clearinghouse designated by OMB the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section for:

- (1) The Federal clearinghouse to retain as an archival copy; and
- (2) Each Federal awarding agency when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the Federal awarding agency provided directly or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the Federal awarding agency provided directly.

(e) *Additional submission by subrecipients.* (1) In addition to the requirements discussed in paragraph (d) of this section, auditees that are also subrecipients shall submit to each pass-through entity one copy of the reporting package described in paragraph (c) of this section for each pass-through entity when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the pass-through entity provided or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the pass-through entity provided.

- (2) Instead of submitting the reporting package to a pass-through entity, when a subrecipient is not required to submit a reporting package to a pass-through entity pursuant to paragraph (e)(1) of this section, the subrecipient shall provide written notification to the pass-through entity that: an audit of the subrecipient was conducted in accordance with this part (including the period covered by the audit and the name, amount, and CFDA number of the Federal award(s) provided by the pass-through entity); the schedule of findings and questioned costs disclosed no audit findings relating to the Federal award(s) that the pass-through entity provided; and, the summary schedule of prior audit findings did not report on the status of any audit findings relating to the Federal award(s) that the pass-through entity provided. A subrecipient may submit a copy of the reporting package described in paragraph (c) of this section to a pass-through entity to comply with this notification requirement.

(f) *Requests for report copies.* In response to requests by a Federal agency or pass-through entity, auditees shall submit the appropriate copies of the reporting package described in paragraph (c) of this section and, if requested, a copy of any management letters issued by the auditor.

(g) *Report retention requirements.* Auditees shall keep one copy of the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section on file for three years from the date of submission to the Federal clearinghouse designated by OMB. Pass-through entities shall keep subrecipients' submissions on file for three years from date of receipt.

(h) *Clearinghouse responsibilities.* The Federal clearinghouse designated by OMB shall distribute the reporting packages received in accordance with paragraph (d)(2) of this section and § __.235(c)(3) to applicable Federal awarding agencies, maintain a data base of completed audits, provide appropriate information to Federal agencies, and follow up with known auditees which have not submitted the required data collection forms and reporting packages.

(i) *Clearinghouse address.* The address of the Federal clearinghouse currently designated by OMB is Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th Street, Jeffersonville, IN 47132.

(j) *Electronic filing.* Nothing in this part shall preclude electronic submissions to the Federal clearinghouse in such manner as may be approved by OMB. With OMB approval, the Federal clearinghouse may pilot test methods of electronic submissions.

Subpart D—Federal Agencies and Pass-Through Entities

§ __.400 Responsibilities.

(a) *Cognizant agency for audit responsibilities.* Recipients expending more than \$25 million a year in Federal awards shall have a cognizant agency for audit. The designated cognizant agency for audit shall be the Federal awarding agency that provides the predominant amount of direct funding to a recipient unless OMB makes a specific cognizant agency for audit assignment. To provide for continuity of cognizance, the determination of the predominant amount of direct funding shall be based upon direct Federal awards expended in the recipient's fiscal years ending in 1995, 2000, 2005, and every fifth year thereafter. For example, audit cognizance for periods ending in 1997 through 2000

will be determined based on Federal awards expended in 1995. (However, for States and local governments that expend more than \$25 million a year in Federal awards and have previously assigned cognizant agencies for audit, the requirements of this paragraph are not effective until fiscal years beginning after June 30, 2000.) Notwithstanding the manner in which audit cognizance is determined, a Federal awarding agency with cognizance for an auditee may reassign cognizance to another Federal awarding agency which provides substantial direct funding and agrees to be the cognizant agency for audit. Within 30 days after any reassignment, both the old and the new cognizant agency for audit shall notify the auditee, and, if known, the auditor of the reassignment. The cognizant agency for audit shall:

- (1) Provide technical audit advice and liaison to auditees and auditors.
- (2) Consider auditee requests for extensions to the report submission due date required by § __.320(a). The cognizant agency for audit may grant extensions for good cause.
- (3) Obtain or conduct quality control reviews of selected audits made by non-Federal auditors, and provide the results, when appropriate, to other interested organizations.
- (4) Promptly inform other affected Federal agencies and appropriate Federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities or illegal acts, as required by GAGAS or laws and regulations.
- (5) Advise the auditor and, where appropriate, the auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor. When advised of deficiencies, the auditee shall work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit shall notify the auditor, the auditee, and applicable Federal awarding agencies and pass-through entities of the facts and make recommendations for follow-up action. Major inadequacies or repetitive substandard performance by auditors shall be referred to appropriate State licensing agencies and professional bodies for disciplinary action.
- (6) Coordinate, to the extent practical, audits or reviews made by or for Federal agencies that are in addition to the audits made pursuant to this part, so that the additional audits or reviews build upon audits performed in accordance with this part.
- (7) Coordinate a management decision for audit findings that affect the Federal programs of more than one agency.
- (8) Coordinate the audit work and reporting responsibilities among auditors to achieve the most cost-effective audit.
- (9) For biennial audits permitted under § __.220, consider auditee requests to qualify as a low-risk auditee under § __.530(a).

(b) *Oversight agency for audit responsibilities.* An auditee which does not have a designated cognizant agency for audit will be under the general oversight of the Federal agency determined in accordance with § __.105. The oversight agency for audit:

- (1) Shall provide technical advice to auditees and auditors as requested.

- (2) May assume all or some of the responsibilities normally performed by a cognizant agency for audit.

(c) *Federal awarding agency responsibilities.* The Federal awarding agency shall perform the following for the Federal awards it makes:

- (1) Identify Federal awards made by informing each recipient of the CFDA title and number, award name and number, award year, and if the award is for R&D. When some of this information is not available, the Federal agency shall provide information necessary to clearly describe the Federal award.
- (2) Advise recipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements.
- (3) Ensure that audits are completed and reports are received in a timely manner and in accordance with the requirements of this part.
- (4) Provide technical advice and counsel to auditees and auditors as requested.
- (5) Issue a management decision on audit findings within six months after receipt of the audit report and ensure that the recipient takes appropriate and timely corrective action.
- (6) Assign a person responsible for providing annual updates of the compliance supplement to OMB.

(d) *Pass-through entity responsibilities.* A pass-through entity shall perform the following for the Federal awards it makes:

- (1) Identify Federal awards made by informing each subrecipient of CFDA title and number, award name and number, award year, if the award is R&D, and name of Federal agency. When some of this information is not available, the pass-through entity shall provide the best information available to describe the Federal award.
- (2) Advise subrecipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements as well as any supplemental requirements imposed by the pass-through entity.
- (3) Monitor the activities of subrecipients as necessary to ensure that Federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- (4) Ensure that subrecipients expending \$300,000 or more in Federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.
- (5) Issue a management decision on audit findings within six months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.
- (6) Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.
- (7) Require each subrecipient to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with this part.

§ __.405 Management decision.

(a) *General.* The management decision shall clearly state whether or not the audit finding is sustained, the reasons for the decision, and the expected auditee

action to repay disallowed costs, make financial adjustments, or take other action. If the auditee has not completed corrective action, a timetable for follow-up should be given. Prior to issuing the management decision, the Federal agency or pass-through entity may request additional information or documentation from the auditee, including a request for auditor assurance related to the documentation, as a way of mitigating disallowed costs. The management decision should describe any appeal process available to the auditee.

(b) *Federal agency.* As provided in §___.400(a)(7), the cognizant agency for audit shall be responsible for coordinating a management decision for audit findings that affect the programs of more than one Federal agency. As provided in §___.400(c)(5), a Federal awarding agency is responsible for issuing a management decision for findings that relate to Federal awards it makes to recipients. Alternate arrangements may be made on a case-by-case basis by agreement among the Federal agencies concerned.

(c) *Pass-through entity.* As provided in §___.400(d)(5), the pass-through entity shall be responsible for making the management decision for audit findings that relate to Federal awards it makes to subrecipients.

(d) *Time requirements.* The entity responsible for making the management decision shall do so within six months of receipt of the audit report. Corrective action should be initiated within six months after receipt of the audit report and proceed as rapidly as possible.

(e) *Reference numbers.* Management decisions shall include the reference numbers the auditor assigned to each audit finding in accordance with §___.510(c).

Subpart E—Auditors

§___.500 Scope of audit.

(a) *General.* The audit shall be conducted in accordance with GAGAS. The audit shall cover the entire operations of the auditee; or, at the option of the auditee, such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year, provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and other organizational unit, which shall be considered to be a non-Federal entity. The financial statements and schedule of expenditures of Federal awards shall be for the same fiscal year.

(b) *Financial statements.* The auditor shall determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally accepted accounting principles. The auditor shall also determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.

(c) *Internal control.* (1) In addition to the requirements of GAGAS, the auditor shall perform procedures to obtain an understanding of internal control over Federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs.

(2) Except as provided in paragraph (c)(3) of this section, the auditor shall:

- (i) Plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program; and
 - (ii) Perform testing of internal control as planned in paragraph (c)(2)(i) of this section.
- (3) When internal control over some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, the planning and performing of testing described in paragraph (c)(2) of this section are not required for those compliance requirements. However, the auditor shall report a reportable condition (including whether any such condition is a material weakness) in accordance with §__.510, assess the related control risk at the maximum, and consider whether additional compliance tests are required because of ineffective internal control.
 - (d) *Compliance.* (1) In addition to the requirements of GAGAS, the auditor shall determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs.
 - (2) The principal compliance requirements applicable to most Federal programs and the compliance requirements of the largest Federal programs are included in the compliance supplement.
 - (3) For the compliance requirements related to Federal programs contained in the compliance supplement, an audit of these compliance requirements will meet the requirements of this part. Where there have been changes to the compliance requirements and the changes are not reflected in the compliance supplement, the auditor shall determine the current compliance requirements and modify the audit procedures accordingly. For those Federal programs not covered in the compliance supplement, the auditor should use the types of compliance requirements contained in the compliance supplement as guidance for identifying the types of compliance requirements to test, and determine the requirements governing the Federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.
 - (4) The compliance testing shall include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance.
 - (e) *Audit follow-up.* The auditor shall follow-up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee in accordance with §__.315(b), and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor shall perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year.
 - (f) *Data Collection Form.* As required in §__.320(b)(3), the auditor shall complete and sign specified sections of the data collection form.

§ __.505 Audit reporting.

The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:

- (a) An opinion (or disclaimer of opinion) as to whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles and an opinion (or disclaimer of opinion) as to whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.
- (b) A report on internal control related to the financial statements and major programs. This report shall describe the scope of testing of internal control and the results of the tests, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.
- (c) A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report shall also include an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on each major program, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.
- (d) A schedule of findings and questioned costs which shall include the following three components:
 - (1) A summary of the auditor's results which shall include:
 - (i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);
 - (ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses;
 - (iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee;
 - (iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses;
 - (v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);
 - (vi) A statement as to whether the audit disclosed any audit findings which the auditor is required to report under § __.510(a);
 - (vii) An identification of major programs;

- (viii) The dollar threshold used to distinguish between Type A and Type B programs, as described in §___.520(b); and
 - (ix) A statement as to whether the auditee qualified as a low-risk auditee under §___.530.
- (2) Findings relating to the financial statements which are required to be reported in accordance with GAGAS.
 - (3) Findings and questioned costs for Federal awards which shall include audit findings as defined in §___.510(a).
 - (i) Audit findings (e.g., internal control findings, compliance findings, questioned costs, or fraud) which relate to the same issue should be presented as a single audit finding. Where practical, audit findings should be organized by Federal agency or pass-through entity.
 - (ii) Audit findings which relate to both the financial statements and Federal awards, as reported under paragraphs (d)(2) and (d)(3) of this section, respectively, should be reported in both sections of the schedule. However, the reporting in one section of the schedule may be in summary form with a reference to a detailed reporting in the other section of the schedule.

§___.510 Audit findings.

(a) *Audit findings reported.* The auditor shall report the following as audit findings in a schedule of findings and questioned costs:

- (1) Reportable conditions in internal control over major programs. The auditor's determination of whether a deficiency in internal control is a reportable condition for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the compliance supplement. The auditor shall identify reportable conditions which are individually or cumulatively material weaknesses.
- (2) Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the compliance supplement.
- (3) Known questioned costs which are greater than \$10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). The auditor shall also report known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program. In reporting questioned costs, the auditor shall include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

- (4) Known questioned costs which are greater than \$10,000 for a Federal program which is not audited as a major program. Except for audit follow-up, the auditor is not required under this part to perform audit procedures for such a Federal program; therefore, the auditor will normally not find questioned costs for a program which is not audited as a major program. However, if the auditor does become aware of questioned costs for a Federal program which is not audited as a major program (e.g., as part of audit follow-up or other audit procedures) and the known questioned costs are greater than \$10,000, then the auditor shall report this as an audit finding.
- (5) The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for Federal awards.
- (6) Known fraud affecting a Federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for Federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of GAGAS.
- (7) Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in accordance with § __.315(b) materially misrepresents the status of any prior audit finding.

(b) *Audit finding detail.* Audit findings shall be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for Federal agencies and pass-through entities to arrive at a management decision. The following specific information shall be included, as applicable, in audit findings:

- (1) Federal program and specific Federal award identification including the CFDA title and number, Federal award number and year, name of Federal agency, and name of the applicable pass-through entity. When information, such as the CFDA title and number or Federal award number, is not available, the auditor shall provide the best information available to describe the Federal award.
- (2) The criteria or specific requirement upon which the audit finding is based, including statutory, regulatory, or other citation.
- (3) The condition found, including facts that support the deficiency identified in the audit finding.
- (4) Identification of questioned costs and how they were computed.
- (5) Information to provide proper perspective for judging the prevalence and consequences of the audit findings, such as whether the audit findings represent an isolated instance or a systemic problem. Where appropriate, instances identified shall be related to the universe and the number of cases examined and be quantified in terms of dollar value.
- (6) The possible asserted effect to provide sufficient information to the auditee and Federal agency, or pass-through entity in the case of a subrecipient, to permit them to determine the cause and effect to facilitate prompt and proper corrective action.

- (7) Recommendations to prevent future occurrences of the deficiency identified in the audit finding.
- (8) Views of responsible officials of the auditee when there is disagreement with the audit findings, to the extent practical.

(c) *Reference numbers.* Each audit finding in the schedule of findings and questioned costs shall include a reference number to allow for easy referencing of the audit findings during follow-up.

§__515 Audit working papers.

(a) *Retention of working papers.* The auditor shall retain working papers and reports for a minimum of three years after the date of issuance of the auditor's report(s) to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. When the auditor is aware that the Federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor shall contact the parties contesting the audit finding for guidance prior to destruction of the working papers and reports.

(b) *Access to working papers.* Audit working papers shall be made available upon request to the cognizant or oversight agency for audit or its designee, a Federal agency providing direct or indirect funding, or GAO at the completion of the audit, as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this part. Access to working papers includes the right of Federal agencies to obtain copies of working papers, as is reasonable and necessary.

§__520 Major program determination.

(a) *General.* The auditor shall use a risk-based approach to determine which Federal programs are major programs. This risk-based approach shall include consideration of: Current and prior audit experience, oversight by Federal agencies and pass-through entities, and the inherent risk of the Federal program. The process in paragraphs (b) through (i) of this section shall be followed.

(b) *Step 1.* (1) The auditor shall identify the larger Federal programs, which shall be labeled Type A programs. Type A programs are defined as Federal programs with Federal awards expended during the audit period exceeding the larger of:

- (i) \$300,000 or three percent (.03) of total Federal awards expended in the case of an auditee for which total Federal awards expended equal or exceed \$300,000 but are less than or equal to \$100 million.
 - (ii) \$3 million or three-tenths of one percent (.003) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$100 million but are less than or equal to \$10 billion.
 - (iii) \$30 million or 15 hundredths of one percent (.0015) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$10 billion.
- (2) Federal programs not labeled Type A under paragraph (b)(1) of this section shall be labeled Type B programs.
 - (3) The inclusion of large loan and loan guarantees (loans) should not result in the exclusion of other programs as Type A programs. When

a Federal program providing loans significantly affects the number or size of Type A programs, the auditor shall consider this Federal program as a Type A program and exclude its values in determining other Type A programs.

- (4) For biennial audits permitted under § __.220, the determination of Type A and Type B programs shall be based upon the Federal awards expended during the two-year period.

(c) *Step 2.* (1) The auditor shall identify Type A programs which are low-risk. For a Type A program to be considered low-risk, it shall have been audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and, in the most recent audit period, it shall have had no audit findings under § __.510(a). However, the auditor may use judgment and consider that audit findings from questioned costs under § __.510(a)(3) and § __.510(a)(4), fraud under § __.510(a)(6), and audit follow-up for the summary schedule of prior audit findings under § __.510(a)(7) do not preclude the Type A program from being low-risk. The auditor shall consider: the criteria in § __.525(c), § __.525(d)(1), § __.525(d)(2), and § __.525(d)(3); the results of audit follow-up; whether any changes in personnel or systems affecting a Type A program have significantly increased risk; and apply professional judgment in determining whether a Type A program is low-risk.

- (2) Notwithstanding paragraph (c)(1) of this section, OMB may approve a Federal awarding agency's request that a Type A program at certain recipients may not be considered low-risk. For example, it may be necessary for a large Type A program to be audited as major each year at particular recipients to allow the Federal agency to comply with the Government Management Reform Act of 1994 (31 U.S.C. 3515). The Federal agency shall notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year to be audited of OMB's approval.

(d) *Step 3.* (1) The auditor shall identify Type B programs which are high-risk using professional judgment and the criteria in § __.525. However, should the auditor select Option 2 under Step 4 (paragraph (e)(2)(i)(B) of this section), the auditor is not required to identify more high-risk Type B programs than the number of low-risk Type A programs. Except for known reportable conditions in internal control or compliance problems as discussed in § __.525(b)(1), § __.525(b)(2), and § __.525(c)(1), a single criteria in § __.525 would seldom cause a Type B program to be considered high-risk.

- (2) The auditor is not expected to perform risk assessments on relatively small Federal programs. Therefore, the auditor is only required to perform risk assessments on Type B programs that exceed the larger of:
- (i) \$100,000 or three-tenths of one percent (.003) of total Federal awards expended when the auditee has less than or equal to \$100 million in total Federal awards expended.
 - (ii) \$300,000 or three-hundredths of one percent (.0003) of total Federal awards expended when the auditee has more than \$100 million in total Federal awards expended.

(e) *Step 4.* At a minimum, the auditor shall audit all of the following as major programs:

- (1) All Type A programs, except the auditor may exclude any Type A programs identified as low-risk under Step 2 (paragraph (c)(1) of this section).
- (2) (i) High-risk Type B programs as identified under either of the following two options:
 - (A) *Option 1.* At least one half of the Type B programs identified as high-risk under Step 3 (paragraph (d) of this section), except this paragraph (e)(2)(i)(A) does not require the auditor to audit more high-risk Type B programs than the number of low-risk Type A programs identified as low-risk under Step 2.
 - (B) *Option 2.* One high-risk Type B program for each Type A program identified as low-risk under Step 2.
- (ii) When identifying which high-risk Type B programs to audit as major under either Option 1 or 2 in paragraph (e)(2)(i)(A) or (B) of this section, the auditor is encouraged to use an approach which provides an opportunity for different high-risk Type B programs to be audited as major over a period of time.
- (3) Such additional programs as may be necessary to comply with the percentage of coverage rule discussed in paragraph (f) of this section. This paragraph (e)(3) may require the auditor to audit more programs as major than the number of Type A programs.

(f) *Percentage of coverage rule.* The auditor shall audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 50 percent of total Federal awards expended. If the auditee meets the criteria in § ____, 530 for a low-risk auditee, the auditor need only audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 25 percent of total Federal awards expended.

(g) *Documentation of risk.* The auditor shall document in the working papers the risk analysis process used in determining major programs.

(h) *Auditor's judgment.* When the major program determination was performed and documented in accordance with this part, the auditor's judgment in applying the risk-based approach to determine major programs shall be presumed correct. Challenges by Federal agencies and pass-through entities shall only be for clearly improper use of the guidance in this part. However, Federal agencies and pass-through entities may provide auditors guidance about the risk of a particular Federal program and the auditor shall consider this guidance in determining major programs in audits not yet completed.

(i) *Deviation from use of risk criteria.* For first-year audits, the auditor may elect to determine major programs as all Type A programs plus any Type B programs as necessary to meet the percentage of coverage rule discussed in paragraph (f) of this section. Under this option, the auditor would not be required to perform the procedures discussed in paragraphs (c), (d), and (e) of this section.

- (1) A first-year audit is the first year the entity is audited under this part or the first year of a change of auditors.
- (2) To ensure that a frequent change of auditors would not preclude audit of high-risk Type B programs, this election for first-year audits may not be used by an auditee more than once in every three years.

§ 525 Criteria for Federal program risk.

(a) *General.* The auditor's determination should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the Federal program. The auditor shall use auditor judgment and consider criteria, such as described in paragraphs (b), (c), and (d) of this section, to identify risk in Federal programs. Also, as part of the risk analysis, the auditor may wish to discuss a particular Federal program with auditee management and the Federal agency or pass-through entity.

(b) *Current and prior audit experience.* (1) Weaknesses in internal control over Federal programs would indicate higher risk. Consideration should be given to the control environment over Federal programs and such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements and the competence and experience of personnel who administer the Federal programs.

- (i) A Federal program administered under multiple internal control structures may have higher risk. When assessing risk in a large single audit, the auditor shall consider whether weaknesses are isolated in a single operating unit (e.g., one college campus) or pervasive throughout the entity.
 - (ii) When significant parts of a Federal program are passed through to subrecipients, a weak system for monitoring subrecipients would indicate higher risk.
 - (iii) The extent to which computer processing is used to administer Federal programs, as well as the complexity of that processing, should be considered by the auditor in assessing risk. New and recently modified computer systems may also indicate risk.
- (2) Prior audit findings would indicate higher risk, particularly when the situations identified in the audit findings could have a significant impact on a Federal program or have not been corrected.
- (3) Federal programs not recently audited as major programs may be of higher risk than Federal programs recently audited as major programs without audit findings.

(c) *Oversight exercised by Federal agencies and pass-through entities.* (1) Oversight exercised by Federal agencies or pass-through entities could indicate risk. For example, recent monitoring or other reviews performed by an oversight entity which disclosed no significant problems would indicate lower risk. However, monitoring which disclosed significant problems would indicate higher risk.

- (2) Federal agencies, with the concurrence of OMB, may identify Federal programs which are higher risk. OMB plans to provide this identification in the compliance supplement.

(d) *Inherent risk of the Federal program.* (1) The nature of a Federal program may indicate risk. Consideration should be given to the complexity of the program and the extent to which the Federal program contracts for goods and services. For example, Federal programs that disburse funds through third party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high-risk for time and effort reporting, but otherwise be at low-risk.

- (2) The phase of a Federal program in its life cycle at the Federal agency may indicate risk. For example, a new Federal program with new or inter-

im regulations may have higher risk than an established program with time-tested regulations. Also, significant changes in Federal programs, laws, regulations, or the provisions of contracts or grant agreements may increase risk.

- (3) The phase of a Federal program in its life cycle at the auditee may indicate risk. For example, during the first and last years that an auditee participates in a Federal program, the risk may be higher due to start-up or closeout of program activities and staff.
- (4) Type B programs with larger Federal awards expended would be of higher risk than programs with substantially smaller Federal awards expended.

§ __.530 Criteria for a low-risk auditee.

An auditee which meets all of the following conditions for each of the preceding two years (or, in the case of biennial audits, preceding two audit periods) shall qualify as a low-risk auditee and be eligible for reduced audit coverage in accordance with § __.520:

- (a) Single audits were performed on an annual basis in accordance with the provisions of this part. A non-Federal entity that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.
- (b) The auditor's opinions on the financial statements and the schedule of expenditures of Federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of Federal awards and provide a waiver.
- (c) There were no deficiencies in internal control which were identified as material weaknesses under the requirements of GAGAS. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of Federal awards and provide a waiver.
- (d) None of the Federal programs had audit findings from any of the following in either of the preceding two years (or, in the case of biennial audits, preceding two audit periods) in which they were classified as Type A programs:
 - (1) Internal control deficiencies which were identified as material weaknesses;
 - (2) Noncompliance with the provisions of laws, regulations, contracts, or grant agreements which have a material effect on the Type A program; or
 - (3) Known or likely questioned costs that exceed five percent of the total Federal awards expended for a Type A program during the year.

Appendix A to Part __—Data Collection Form (Form SF-SAC)

[Insert SF-SAC after finalized]

Appendix B to Part __—Circular A-133 Compliance Supplement

Note: Provisional OMB Circular A-133 Compliance Supplement is available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503.

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APPENDIX C

Illustrative Schedules of Expenditures of Federal Awards

Example Entity
Schedule of Expenditures of Federal Awards¹
For the Year Ended June 30, 19X1²

| <i>Federal Grantor / Pass-Through Grantor / Program or Cluster Title</i> | <i>Federal CFDA Number³</i> | <i>Pass-Through Entity Identifying Number⁴</i> | <i>Federal Expenditures⁵</i> |
|--|--|---|---|
| U.S. Department of Agriculture: | | | |
| Summer Food Service Program for Children—Commodities | 10.559 | | \$ 46,000 |
| <i>Total U.S. Department of Agriculture</i> | | | <u>\$ 46,000</u> |
| U.S. Department of Housing and Urban Development: | | | |
| Community Development Block Grant—Entitlement Grants (note 2) | 14.218 | | \$1,235,632 |
| Section 8 Rental Voucher Program | 14.855 | | <u>800,534</u> |
| <i>Total U.S. Department of Housing and Urban Development</i> | | | <u>\$2,036,166</u> |
| U.S. Department of Education: | | | |
| Impact Aid | 84.041 | | \$ 372,555 |
| Bilingual Education | 84.288 | | <u>28,655</u> |
| Subtotal Direct Programs | | | \$ 401,210 |
| Pass-Through Program From: | | | |
| State Department of Education—Title I Grants to Local Educational Agencies | 84.010 | 23-8345-7612 | <u>\$1,239,398</u> |
| <i>Total U.S. Department of Education</i> | | | <u>\$1,640,608</u> |
| Total Expenditures of Federal Awards | | | <u>\$3,722,774</u> |

The accompanying notes are an integral part of this schedule.

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

² Additional guidance on the schedule is provided in chapter 5 which includes a discussion of the identification of federal awards, the general presentation requirements governing the schedule, pass-through awards, noncash awards, and endowment funds. Chapter 5 also includes a discussion of the auditor's responsibility for reporting on the schedule.

³ When the CFDA number is not available, the auditee should indicate that the CFDA number is not available and include in the schedule the program's name and, if available, other identifying number.

⁴ When awards are received as a subrecipient, the identifying number assigned by the pass-through entity should be included in the schedule.

⁵ Circular A-133 requires that the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end be included in either the schedule or a note to the schedule. Although it is not required, Circular A-133 states that it is preferable to present this information in the schedule (versus the notes to the schedule). If the auditee presents noncash assistance in the notes to the schedule, the auditor should be aware that such amounts must still be included in part III of the data collection form.

Example Entity
Notes to the Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 19X1

Note 1. Basis of Presentation⁶

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

Note 2. Subrecipients⁷

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

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

⁶ This note is included to meet the Circular A-133 requirement that the schedule include notes that describe the significant accounting policies used in preparing the schedule.

⁷ Circular A-133 requires the schedule of expenditures of federal awards to include, to the extent practical, an identification of the total amount provided to subrecipients from each federal program. Although this example includes the required subrecipient information in the notes to the schedule, the information may be included on the face of the schedule as a separate column or section, if that is preferred by the auditee.

Example Entity University
Schedule of Expenditures of Federal Awards⁸
For the Year Ended June 30, 19X1⁹

| <i>Federal Grantor/Pass-Through Grantor/Program or Cluster Title</i> | <i>Federal CFDA Number¹⁰</i> | <i>Pass-Through Entity Identifying Number¹¹</i> | <i>Federal Expenditures¹²</i> |
|--|---|--|--|
| <i>Student Financial Aid—Cluster:</i> | | | |
| U.S. Department of Education: | | | |
| Federal Pell Grant Program | 84.063 | | \$ 8,764,943 |
| Federal Supplemental Educational Opportunity Grant | 84.007 | | 974,873 |
| Federal Work-Study Program | 84.033 | | 575,417 |
| Federal Perkins Loan Program (note 2) | 84.038 | | <u>1,548,343</u> |
| <i>Total U.S. Department of Education</i> | | | <u>\$11,863,576</u> |
| U.S. Department of Health and Human Services: | | | |
| Nursing Student Loans (note 2) | 93.364 | | \$ 823,582 |
| <i>Total U.S. Department of Health and Human Services</i> | | | <u>\$ 823,582</u> |
| <i>Total Student Financial Aid</i> | | | <u>\$12,687,158</u> |
| <i>Research and Development—Cluster:¹³</i> | | | |
| U.S. Department of Defense: | | | |
| Department of Army | N.A. | | \$ 87,403 |
| Office of Naval Research | N.A. | | <u>73,107</u> |
| Subtotal Direct Programs | | | <u>\$ 160,510</u> |
| Pass-Through Programs From: | | | |
| XYZ Labs—Effects of Ice on Radar Images | N.A. | 4532 | <u>\$ 11,987</u> |
| <i>Total U.S. Department of Defense</i> | | | <u>\$ 172,497</u> |
| National Science Foundation: | | | |
| National Science Foundation (note 3) | N.A. | | \$ 432,111 |
| Pass-Through Programs From: | | | |
| ABC University—Atmospheric Effects of Volcano Eruptions | N.A. | Abc97-8 | <u>\$ 25,987</u> |
| <i>Total National Science Foundation</i> | | | <u>\$ 458,098</u> |
| U.S. Department of Health and Human Services: | | | |
| National Institutes of Health | N.A. | | \$ 675,321 |
| Administration on Aging (note 3) | N.A. | | <u>234,987</u> |
| Subtotal Direct Programs | | | <u>\$ 910,308</u> |

⁸ See footnote 1.

⁹ See footnote 2.

¹⁰ See footnote 3.

¹¹ See footnote 4.

¹² See footnote 5.

¹³ For R&D, Circular A-133 requires that total federal awards expended must be shown either by individual award or by federal agency and major subdivision within the federal agency. This example illustrates the federal agency and major subdivision option.

| <i>Federal Grantor / Pass-Through Grantor / Program or Cluster Title</i> | <i>Federal CFDA Number¹⁰</i> | <i>Pass-Through Entity Identifying Number¹¹</i> | <i>Federal Expenditures¹²</i> |
|--|---|--|--|
| Pass-Through Programs From: | | | |
| ABC Hospital—Heart Research | N.A. | 5489-5 | \$ 432,765 |
| State Health Department—Food Safety Research | N.A. | SG673-45 | <u>123,987</u> |
| Subtotal Pass-Through Programs | | | \$ 556,752 |
| <i>Total U.S. Department of Health and Human Services</i> | | | \$ 1,467,060 |
| <i>Total Research and Development Other Programs:</i> | | | \$ 2,097,655 |
| U.S. Department of Energy: | | | |
| Educational Exchange—University Lectures and Research | 82.002 | | \$ 17,823 |
| Total U.S. Department of Energy | | | \$ 17,823 |
| U.S. Department of Education: | | | |
| TRIO Talent Search | 84.044 | | \$ 308,465 |
| Safe and Drug-Free Schools and Communities | 84.184 | | <u>59,723</u> |
| Subtotal Direct Programs | | | \$ 368,188 |
| Pass-Through Programs From: | | | |
| State Department of Education—Vocational Education Basic Grant | 84.048 | 874-90-5473 | \$ 3,115 |
| State Department of Education—Tech-Prep Education | 84.243 | 25-8594-2167 | <u>176,885</u> |
| Subtotal Pass-Through Programs | | | \$ 180,000 |
| <i>Total U.S. Department of Education</i> | | | \$ 548,188 |
| <i>Total Other Programs</i> | | | \$ 566,011 |
| <i>Total Expenditures of Federal Awards</i> | | | <u>\$15,350,824</u> |
| N.A. = Not Available | | | |

The accompanying notes are an integral part of this schedule.

Example Entity University
Notes to the Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 19X1

Note 1. Basis of Presentation¹⁴

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

Note 2. Loans Outstanding¹⁵

Example Entity University had the following loan balances outstanding at June 30, 19X1. These loan balances outstanding are also included in the federal expenditures presented in the schedule.

| <i>Cluster / Program Title</i> | <i>Federal CFDA Number</i> | <i>Amount Outstanding</i> |
|--------------------------------|--------------------------------|-------------------------------|
| Federal Perkins Loan Program | 84.038 | \$1,268,236 |
| Nursing Student Loans | 93.364 | \$ 763,127 |

Note 3. Subrecipients¹⁶

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

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

¹⁴ See footnote 6.

¹⁵ This note is intended to meet the Circular A-133 requirement that loans or loan guarantees outstanding at year end be included in the schedule.

¹⁶ See footnote 7.

APPENDIX D

Illustrative Auditor's Reports

D.1. This appendix contains examples of the reports issued under GAAS, *Government Auditing Standards*, and Circular A-133 in various circumstances for a single audit. Also included are examples of the reports issued for a program-specific audit.

D.2. As discussed in chapter 10, reporting on a financial statement audit and on the compliance requirements applicable to each major program involves varying levels of materiality and different forms of reporting. Circular A-133 states that the auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in the circular. In an effort to make the reports understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued for a single audit (the basic elements of each of the recommended reports are discussed in chapter 10):

- An opinion on the financial statements and on the supplementary schedule of expenditures of federal awards
- A report on compliance and on the internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*
- A report on compliance with requirements applicable to each major program and on the internal control over compliance in accordance with Circular A-133

D.3. Furthermore, as discussed in chapter 11, this SOP recommends that the following reports be issued for a program-specific audit (see paragraph 11.10 for a discussion of the possible issuance of a separate report to meet the reporting requirements of *Government Auditing Standards*): (a) an opinion on the financial statement(s) of the federal program and (b) a report on compliance with requirements applicable to the federal program and on the internal control over compliance in accordance with the program-specific audit option under Circular A-133.

D.4. Auditors need to understand the intended purpose of the reports and should tailor the reporting to the specific auditee's situation. Because the reports issued to comply with Circular A-133 involve varying levels of materiality and different forms of reporting, auditors should exercise care in issuing reports to ensure that they meet all of the varying reporting requirements of GAAS, *Government Auditing Standards*, and Circular A-133. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

D.5. The following example auditor's reports illustrate the types of reports to be issued in selected situations. Chapters 10 and 11 of this SOP include discussions of certain of the situations and the resulting reports contained herein. For additional guidance the auditor should refer to SAS No. 58, *Reports on Audited Financial Statements*.

D.6. The following is a list of the example reports in this appendix:

| <i>Example No.</i> | <i>Title</i> |
|--------------------|---|
| 1 | Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Governmental Entity |
| 1a | Unqualified Opinion on Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Not-for-Profit Organization |
| 2 | Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i> (No Reportable Instances of Noncompliance and No Material Weaknesses [No Reportable Conditions Identified]) |
| 2a | Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i> (<i>Reportable Instances of Noncompliance and Reportable Conditions Identified</i>) |
| 3 | Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified]</i>) |
| 3a | Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Qualified Opinion on Compliance and Reportable Conditions Identified</i>) |
| 4 | Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Qualified Opinion on Compliance—Scope Limitation for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, Reportable Conditions Identified</i>) |
| 5 | Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Adverse Opinion on Compliance for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, and Material Weaknesses Identified</i>) |
| 6 | Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133 |
| 6a | Report on Compliance With Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133 (<i>Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified]</i>) |

Example 1

Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Governmental Entity¹

Independent Auditor's Report

[Addressee]

We have audited the accompanying general-purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,² 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of the City of Example's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.³

The accompanying schedule of expenditures of federal awards⁴ is presented for purposes of additional analysis as required by U.S. Office of Management and

¹ Auditors may also refer to the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* for additional guidance on reporting on the general-purpose financial statements of a government.

² The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

³ The following paragraph should be deleted if the schedule of expenditures of federal awards is not presented with the general-purpose financial statements (that is, a separate single audit package is issued). In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. See footnotes 34 and 40 for additional guidance.

⁴ If the auditor is reporting on additional supplementary information (for example, combining and individual fund and account group financial statements and schedules), this paragraph should be modified to describe the additional supplementary information. The example reports in appendix A of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), provide useful guidance.

Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the general-purpose financial statements. Such information has been subjected to the auditing procedures applied in the audit of the general-purpose financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the general-purpose financial statements taken as a whole.⁵

[Signature]

[Date]

⁵ When reporting on the supplementary information, the auditor should consider the effect of any modifications to the report on the general-purpose financial statements. Furthermore, if the report on supplementary information is other than unqualified, this paragraph should be modified. Guidance for reporting in these circumstances is described in paragraphs 9 through 11, 13, and 14 of SAS No. 29 (AICPA, *Professional Standards*, vol. 1, AU sec. 551.09-.11, .13, and .14).

Example 1a

Unqualified Opinion on Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Not-for-Profit Organization⁶

Independent Auditor's Report

[Addressee]

We have audited the accompanying statement of financial position of Example NFP as of June 30, 19X1, and the related statements of activities and cash flows⁷ for the year then ended. These financial statements are the responsibility of Example NFP's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,⁸ 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Example NFP as of June 30, 19X1, and the changes in its net assets and its cash flows for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of Example NFP's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.⁹

The accompanying schedule of expenditures of federal awards¹⁰ is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.¹¹

[Signature]

[Date]

⁶ Auditors may also refer to the AICPA Audit and Accounting Guide *Not-For-Profit Organizations* for additional guidance on reporting on the financial statements of a not-for-profit organization.

⁷ If the not-for-profit organization is a voluntary health and welfare organization, this phrase should be modified to state "and the related statements of activities, functional expenses and cash flows."

⁸ See footnote 2.

⁹ See footnote 3.

¹⁰ If the auditor is reporting on additional supplementary information (for example, a comparison of actual and budgeted expenses), this paragraph should be modified to describe the additional supplementary information. SAS No. 29 provides useful guidance.

¹¹ See footnote 5.

Example 2

**Report on Compliance and on Internal Control Over
Financial Reporting¹² Based on an Audit of Financial
Statements Performed in Accordance With *Government
Auditing Standards (No Reportable Instances of
Noncompliance and No Material Weaknesses [No
Reportable Conditions Identified])*¹³**

[Addressee]

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.¹⁴ We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,¹⁵ issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.^{16, 17}

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Example Entity's internal control over financial reporting 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 over financial reporting. Our consideration of the internal control over financial reporting would not neces-

¹² See paragraph 4.12 for a description of internal control over financial reporting.

¹³ The auditor should use the portions of examples 2 and 2a that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of example 2a. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of example 2a.

¹⁴ Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors).

¹⁵ See footnote 2.

¹⁶ See paragraphs 5.18 and 5.19 of *Government Auditing Standards* for the criteria for reporting.

¹⁷ If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "However, we noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with paragraph 5.20 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

sarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements 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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.¹⁸

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.^{19, 20}

[Signature]

[Date]

¹⁸ If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "However, we noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

¹⁹ If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended solely for the information and use of the audit committee, management, and *[specify legislative or regulatory body]* and is not intended to be and should not be used by anyone other than these specified parties."

²⁰ This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports.

Example 2a

**Report on Compliance and on Internal Control Over
Financial Reporting²¹ Based on an Audit of Financial
Statements Performed in Accordance With Government
Auditing Standards (Reportable Instances of
Noncompliance and Reportable Conditions Identified)²²**

[Addressee]

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.²³ We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,²⁴ issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*²⁵ and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-2 and 97-5].²⁶

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Example Entity's internal control over financial reporting 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 over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect Example Entity's ability to record, process, summarize, and report financial data consistent with the

²¹ See footnote 12.

²² See footnote 13.

²³ See footnote 14.

²⁴ See footnote 2.

²⁵ See footnote 16.

²⁶ If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "We also noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with chapter 5, paragraph 5.20 of *Government Auditing Standards*, which indicates that communications to "top" management should be referred to.

assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-1, 97-4, and 97-8].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements 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 over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.^{27, 28}

This report is intended solely for the information and use of the audit committee, management, [specify legislative or regulatory body], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.^{29, 30}

[Signature]

[Date]

²⁷ If conditions believed to be material weaknesses are disclosed, the report should identify the material weaknesses that have come to the auditor's attention. The last sentence of this paragraph should be replaced with language such as the following: "However, of the reportable conditions described above, we consider items [list the reference numbers of the related findings, for example, 97-1 and 97-8] to be material weaknesses."

²⁸ If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "We also noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

²⁹ If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended solely for the information and use of the audit committee, management, and [specify legislative or regulatory body] and is not intended to be and should not be used by anyone other than these specified parties." All references to the schedule of findings and questioned costs should also be removed, and instead, a description of the findings should be included in the report.

³⁰ See footnote 20.

Example 3

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified])³¹

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,³² issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 19X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-3 and 97-6].³³

³¹ The auditor should use the portions of examples 3 and 3a that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of example 3a. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of example 3a.

³² See footnote 2.

³³ When there are no such instances of noncompliance identified in the schedule of findings and questioned costs, the last sentence should be omitted.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.³⁴

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.³⁵

[*Signature*]

[*Date*]

³⁴ As noted in notes 3 and 9, there may be instances in which it would be appropriate to report on the schedule of expenditures of federal awards in this report (that is, a separate single audit package is issued). In such a circumstance, a new section should be added immediately following this paragraph as follows:

Schedule of Expenditures of Federal Awards

We have audited the [*general-purpose or basic*] financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1. Our audit was performed for the purpose of forming an opinion on the [*general-purpose or basic*] financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the [*general-purpose or basic*] financial statements. Such information has been subjected to the auditing procedures applied in the audit of the [*general-purpose or basic*] financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the [*general-purpose or basic*] financial statements taken as a whole.

Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors). Auditors should also refer to notes 5 and 11 for additional guidance.

³⁵ See footnote 20.

Example 3a

**Report on Compliance With Requirements
Applicable to Each Major Program and on
Internal Control Over Compliance in Accordance
With OMB Circular A-133 (*Qualified Opinion
on Compliance and Reportable Conditions Identified*)³⁶**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,³⁷ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in item [*list the reference numbers of the related findings, for example, 97-10*] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [*identify the type(s) of compliance requirement*] that are applicable to its [*identify the major federal program*]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 19X1.³⁸

³⁶ See footnote 31.

³⁷ See footnote 2.

³⁸ When other instances of noncompliance are identified in the schedule of findings and questioned costs as required by Circular A-133, the following sentence should be added: "The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-3 and 97-6*]."

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9*].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program 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 over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.^{39, 40}

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.⁴¹

[*Signature*]

[*Date*]

³⁹ See footnote 27.

⁴⁰ See footnote 34.

⁴¹ See footnote 20.

Example 4

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (Qualified Opinion on Compliance—Scope Limitation for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, Reportable Conditions Identified)

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,⁴² issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

We were unable to obtain sufficient documentation supporting the compliance of Example Entity with [identify the major federal program] regarding [identify the type(s) of compliance requirement], nor were we able to satisfy ourselves as to Example Entity's compliance with those requirements by other auditing procedures.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding Example Entity's compliance with the requirements of [identify the major federal program] regarding [identify the type(s) of compliance requirement], Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 19X1.⁴³

⁴² See footnote 2.

⁴³ See footnote 38.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as *items* [list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program 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 over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.^{44, 45}

This report is intended solely for the information and use of the audit committee, management, [specify legislative or regulatory body], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.⁴⁶

[Signature]

[Date]

⁴⁴ See footnote 27.

⁴⁵ See footnote 34.

⁴⁶ See footnote 20.

Example 5

**Report on Compliance With Requirements Applicable to
Each Major Program and on Internal Control Over
Compliance in Accordance With OMB Circular A-133
(Adverse Opinion on Compliance for One Major Program,
Unqualified Opinion on Compliance for Other Major
Programs, and Material Weaknesses Identified)**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,⁴⁷ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in items [*list the reference numbers of the related findings, for example, 97-10, 97-11, and 97-12*] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [*identify the types of compliance requirements*] that are applicable to its [*identify the major federal program*]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with requirements applicable to that program.

In our opinion, because of the effects of the noncompliance described in the preceding paragraph, Example Entity did not comply in all material respects, with the requirements referred to above that are applicable to [*identify the major federal program*]. Also, in our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 19X1.⁴⁸

⁴⁷ See footnote 2.

⁴⁸ See footnote 38.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items *[list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9]*.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program 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 over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items *[list the reference numbers of the related findings, for example 97-8 and 97-9]* to be material weaknesses.⁴⁹

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.⁵⁰

[Signature]

[Date]

⁴⁹ See footnote 34.

⁵⁰ See footnote 20.

Example 6

Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133

Independent Auditor's Report

We have audited the accompanying schedule of expenditures of federal awards for the [identify the federal program] of Example Entity for the year ended June 30, 19X1. This financial statement is the responsibility of Example Entity's management. Our responsibility is to express an opinion on the financial statement of the program based on our audit.⁵¹

We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,⁵² issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of expenditures of federal awards referred to above⁵³ presents fairly, in all material respects, the expenditures of federal awards under the [identify the federal program] in conformity with generally accepted accounting principles.^{54, 55}

[Signature]

[Date]

⁵¹ In many cases, the financial statements of the program will consist only of the schedule of expenditures of federal awards (and notes to the schedule), which is the minimum financial statement presentation required by section 235 of Circular A-133. If the auditee issues financial statements that consist of more than the schedule, this paragraph should be modified to describe the financial statements. Also refer to paragraph 11.10 for a discussion of the possible necessity to issue a separate report to meet the reporting requirements of *Government Auditing Standards*.

⁵² See footnote 2.

⁵³ If the auditee issues financial statements that consist of more than the schedule, this sentence should be modified to identify the results displayed in the financial presentation.

⁵⁴ The auditor should follow the guidance in SAS No. 62, *Special Reports* when the auditee prepares the financial statement of the program in conformity with a basis of accounting other than GAAP.

⁵⁵ If a separate report is issued to meet the reporting requirements of *Government Auditing Standards* (see paragraph 11.10), an additional paragraph should be added as follows: "In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of Example Entity's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants."

Example 6a

Report on Compliance With Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133⁵⁶ (Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified])⁵⁷

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to [identify the federal program] for the year ended June 30, 19X1. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,⁵⁸ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on [identify the federal program] occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to its [identify the federal program] for the year ended June 30, 19X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-1 and 97-2].⁵⁹

⁵⁶ This is an example of a report on a program-specific audit under Circular A-133 when no federal audit guide applicable to the program being audited is available. When a federal audit guide applicable to the program is available, Circular A-133 requires that the auditor follow the reporting requirements of that federal audit guide (see paragraph 11.4 for a discussion of the auditor's responsibility when a program-specific audit guide is not current).

⁵⁷ If issuing a qualified or adverse opinion on compliance, the auditor should modify the compliance section of this report to be consistent with the wording used in examples 3a or 5, accordingly. If reporting reportable conditions, including material weaknesses, the auditor should modify the internal control section of this report to be consistent with the wording used in example 3a.

⁵⁸ See footnote 2.

⁵⁹ See footnote 33.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on its [*identify the federal program*] in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and the federal awarding agency and pass-through entity and is not intended to be and should not be used by anyone other than these specified parties.⁶⁰

[*Signature*]

[*Date*]

⁶⁰ See footnote 20.

APPENDIX E

Illustrative Schedule of Findings and Questioned Costs

Example Entity
Schedule of Findings and Questioned Costs
For the Year Ended June 30, 19X1

Section I—Summary of Auditor’s Results

Financial Statements

Type of auditor’s report issued [unqualified, qualified, adverse, or disclaimer]:

Internal control over financial reporting:

- Material weakness(es) identified?
• Reportable condition(s) identified that are not considered to be material weaknesses?

Noncompliance material to financial statements noted?

Federal Awards

Internal control over major programs:

- Material weakness(es) identified?
• Reportable condition(s) identified that are not considered to be material weakness(es)?

Type of auditor’s report issued on compliance for major programs [unqualified, qualified, adverse, or disclaimer]:

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133?

Identification of major programs:

Table with 2 columns: CFDA Number(s) and Name of Federal Program or Cluster

1 If the audit report for one or more major programs is other than unqualified, indicate the type of report issued for each program. For example, if the audit report on major program compliance for an auditee having five major programs includes an unqualified opinion for three of the programs, a qualified opinion for one program, and a disclaimer of opinion for one program, the response to this question could be as follows: “Unqualified for all major programs except for [name of program], which was qualified and [name of program], which was a disclaimer.”

2 Major programs should generally be identified in the same order as reported on the schedule of expenditures of federal awards.

3 When the CFDA number is not available, include other identifying number, if applicable.

4 The name of the federal program or cluster should be the same as that listed in the schedule of expenditures of federal awards. For clusters, auditors are only required to list the name of the cluster and not each individual program within the cluster.

Dollar threshold used to distinguish
between type A and type B programs: \$ _____
Auditee qualified as low-risk auditee? _____ yes _____ no

Section II—Financial Statement Findings

[This section identifies the reportable conditions, material weaknesses, and instances of noncompliance related to the financial statements that are required to be reported in accordance with paragraphs 5.18 through 5.20 of Government Auditing Standards. Auditors should refer to those paragraphs, as well as the reports content section of chapter 7 of Government Auditing Standards, for additional guidance on preparing this section of the schedule.]

Identify each finding with a reference number.⁵ If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that effects an entity as a whole, including its federal awards, would generally be reported in detail in this section. Section III would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:

- *Criteria or specific requirement*
- *Condition*
- *Questioned costs*
- *Context⁶*
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response⁷*

Section III—Federal Award Findings and Questioned Costs

[This section identifies the audit findings required to be reported by section 510(a) of Circular A-133 (for example, reportable conditions, material weaknesses, and instances of noncompliance, including questioned costs). Where practical, findings should be organized by federal agency or pass-through entity.]

Identify each finding with a reference number.⁸ If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section

⁵ A suggested format for assigning reference numbers is to use the last two digits of the fiscal year being audited, followed by a numeric sequence of findings. For example, findings identified and reported in the audit of fiscal year 1997 would be assigned reference numbers of 97-1, 97-2, etc.

⁶ Provide sufficient information for judging the prevalence and consequences of the finding, such as the relation to the universe of costs and/or the number of items examined and quantification of audit findings in dollars.

⁷ See paragraphs 5.18 through 5.20 and 7.38 through 7.42 of *Government Auditing Standards* for additional guidance on reporting management's response.

⁸ See footnote 5.

III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a finding of noncompliance with a federal program law that is also material to the financial statements would generally be reported in detail in this section. Section II would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:

- *Information on the federal program*⁹
- *Criteria or specific requirement (including statutory, regulatory, or other citation)*
- *Condition*¹⁰
- *Questioned costs*¹¹
- *Context*¹²
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response*¹³

⁹ Provide the federal program (CFDA number and title) and agency, the federal award's number and year, and the name of the pass-through entity, if applicable. When this information is not available, the auditor should provide the best information available to describe the federal award.

¹⁰ Include facts that support the deficiency identified in the audit finding.

¹¹ Identify questioned costs as required by sections 510(a)(3) and 510(a)(4) of Circular A-133.

¹² See footnote 6.

¹³ To the extent practical, indicate when management does not agree with the finding, questioned cost, or both.

Appendix N

Illustrative Request to Actuary for Confirmation of GASB Pension Information

Instructions

This illustrative letter, which accompanies draft pension information for notes to the financial statements, required supplementary information, and any other appropriate GASB pension presentation, is prepared on the client's letterhead and mailed by the auditor in envelopes bearing the auditor's return address.

It is used when auditing the financial statements of all state and local governmental employers that provide or participate in pension plans, including general purpose governments, public benefit corporations and authorities, utilities, hospitals and other healthcare providers, colleges and universities, and public employee retirement systems that are employers. It also is used when auditing pension plans or retirement systems included as pension trust funds or component units in the financial reports of plan sponsors or employers. These pension plans and retirement systems provide retirement income and also may provide other types of postemployment benefits.

In determining which individuals to include in the Listing of Selected Pension Plan Participant Census Data (illustrated as an attachment to the actuary request letter), the auditor may consider the following suggestions:

- Include the lesser of 20 individuals or 10 percent of participants, but no more than 200 individuals.
- Include samples from actives, retirees, and terminated vested.
- If plan has multiple benefit provisions, include a sample of each group.

[Date]

[Name of Actuary
Name of Actuarial Firm
Address of Actuarial Firm]

Dear [Name of Actuary]:

In connection with the audit of the financial statements of [name of entity or plan] for the year ended [date], please review for consistency with the actuarial report that you prepared dated [date], the attached draft note to the financial statements and [describe other material included (e.g., required supplementary information)]. Your review should include, to the extent applicable, the computation of the annual pension cost and the net pension obligation, that we have prepared in conformity with GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employees*, and the schedules of funding progress and employer contributions that we have prepared in conformity with GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*. Please forward your comments to our auditors, [name and address of auditor]. Your review should focus on, and your comments should address, all applicable information, including the following:

1. The actuarial accrued liability and the actuarial value of assets, as defined in GASB Statement Nos. 25 and 27
2. The actuarial valuation date
3. The description of the actuarial methods and significant assumptions used to determine the annual required contribution
4. The annual required contribution, interest on net pension obligation, adjustment to annual required contribution, contributions made, change in net pension obligation, and ending net pension obligation; the actuarial cost method being used; a description of the actuarial assumptions used; and the aggregate effect of any change in the method or assumption(s)
5. The schedule of funding progress, as defined in GASB Statement No. 25
6. The schedule of employer contributions, as defined in GASB Statement No. 25
7. The description of the employee group covered
8. The general description of the benefit provisions of the plan used in the actuarial valuation
9. The effective date and a description of each plan amendment, including cost-of-living adjustments, included in this actuarial valuation that was not included in the prior valuation

Please also respond to the following:

1. Were the actuarial valuation calculations performed in compliance with the parameters according to GASB Statement Nos. 25 and 27?
2. Have you been notified of a decision by the government to fully or partially terminate or close the plan? If so, please describe the effect on the plan.
3. Describe the nature of the relationship, if any, that you may have with the plan or the sponsor and that may appear to impair the objectivity of your work.
4. What is the amount of the unbilled and/or unpaid actuarial or other fees due your firm applicable to the plan year-end and payable by the plan?
5. Please supply any additional information that you believe is necessary.

Please also provide the attached additional information relating to the specific individuals contained in the census data used in performing the actuarial valuation.

Please reply to [name of auditor] by [date] so that they may complete their audit procedures on a timely basis.

Very truly yours,

[Client Officer]

Attachment

Attachment to Actuary Request Letter
Listing of Selected Pension Plan Participant Census Data

Plan _____

Census Data as of _____

| <u>Participant's Name or Number</u> | <u>Age or Birth Date</u> | <u>Sex</u> | <u>Salary (if applicable)</u> | <u>Date Hired or Years of Service</u> |
|---|----------------------------------|------------|-----------------------------------|---|
| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |
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| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |

Please check the appropriate statement, make corrections as necessary, and complete the information below.

- _____ The attached census information is correct according to our records.
- _____ The attached census information is incorrect according to our records. Corrections are noted above or on a separate attachment.

Actuary / Title _____
Date

Name of Actuarial Firm

Appendix O

Schedule of Changes Made to Audits of State and Local Governmental Units

| <u>Reference</u> | <u>Change</u> | <u>Date</u> |
|--------------------------------|---|---------------|
| Preface | Updated. | May, 1999 |
| Paragraph 1.01 | Revised to reflect the issuance of the Single Audit Act Amendment of 1996 and SOP 98-3. | July, 1998 |
| Paragraph 1.02 | Revised to reflect the issuance of SAS No. 74. | August, 1995 |
| Paragraph 1.03 | Bureau of Census statistic updated. | August, 1995 |
| Paragraph 1.03 (footnote 1) | Deleted outdated reference to 1987 report. | July, 1998 |
| Paragraph 1.04 | Revised for clarity. | August, 1995 |
| Paragraph 1.05 | Revised to reflect the issuance of the revised Audit and Accounting Guide <i>Not-for-Profit Organizations</i> . | October, 1996 |
| Paragraph 1.06 | Revised to reflect the issuance of the revised Audit and Accounting Guide <i>Health Care Organizations</i> . | October, 1996 |
| Paragraph 1.06 | Revised to reflect the issuance of SOP 98-3. | July, 1998 |
| Paragraph 1.07 | Revised to reflect the issuance of GASB Statement Nos. 25, 26, and 27. | July, 1998 |
| Paragraph 1.08 | Added to reflect the issuance of GASB Statement No. 29; Subsequent paragraphs renumbered. | October, 1996 |
| Paragraph 1.08a | Revised to reflect the issuance of SOP 98-2. | July, 1998 |
| Renumbered paragraph 1.12 | Revised to reflect the definition of government. | October, 1996 |
| Renumbered paragraph 1.14 | Revised to reflect the issuance of the Single Audit Act Amendments of 1996 and SOP 98-3. | July, 1998 |
| Renumbered paragraph 1.15 | Revised to conform to 1994 <i>Government Auditing Standards</i> . | August, 1995 |
| Renumbered paragraph 1.16 | Revised to reflect the issuance of SOP 98-3. | July, 1998 |
| Renumbered paragraph 1.20 | Revised to reflect the issuance of SAS No. 74; Footnote 4 deleted. | August, 1995 |
| Renumbered paragraph 1.21 | Revised to conform to 1994 <i>Government Auditing Standards</i> ; Footnote 5 replaced. | August, 1995 |

| <u>Reference</u> | <u>Change</u> | <u>Date</u> |
|-------------------------------------|--|--------------|
| Renumbered paragraph 1.21 | Removed reference to the Single Audit Act as a result of the issuance of SOP 98-3. | July, 1998 |
| Renumbered paragraphs 1.22 and 1.23 | Revised to conform to 1994 <i>Government Auditing Standards</i> . | August, 1995 |
| Renumbered paragraph 1.23 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Renumbered paragraph 1.25 | Revised to reflect the issuance of OMB Circular A-133, the <i>OMB Circular A-133 Compliance Supplement</i> , and SOP 98-3. | July, 1998 |
| Former paragraphs 1.26 and 1.29 | Deleted; Subsequent paragraphs renumbered. | July, 1998 |
| Paragraphs 2.01 and 2.17 | Revised for clarity. | July, 1998 |
| Paragraph 2.19 | Added reference to GASB Question and Answers document on GASB Statement No. 14. | July, 1998 |
| Paragraph 3.01 | Added a reference in the 8th bullet to the communications required by 1994 <i>Government Auditing Standards</i> ; 11th bullet revised for clarity. | August, 1995 |
| Paragraph 3.01 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Paragraph 3.02 | Revised to reflect the issuance of SAS No. 83. | July, 1998 |
| Paragraph 3.04 | Paragraph added; Subsequent paragraphs renumbered. | August, 1995 |
| Paragraph 3.04 | Revised to reflect the issuance of the Single Audit Act Amendments of 1996 and SAS No. 78. | July, 1998 |
| Renumbered paragraph 3.06 | Revised to reflect the issuance of the Single Audit Act Amendments of 1996 and SOP 98-3. | July, 1998 |
| Renumbered paragraph 3.10 | Removed references to single audits as a result of the issuance of SOP 98-3. | July, 1998 |
| Renumbered paragraphs 3.11 and 3.12 | Removed references to single audits as a result of the issuance of SOP 98-3. | July, 1998 |
| Renumbered paragraph 3.12 | Revised for clarity. | August, 1995 |
| Renumbered paragraphs 3.16 and 3.17 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |

| <u>Reference</u> | <u>Change</u> | <u>Date</u> |
|--|---|---------------|
| Renumbered paragraph 3.18 | Revised to reflect the issuance of SAS Nos. 82 and 84. | July, 1998 |
| Renumbered paragraph 3.21 | Revised to reflect the issuance of SAS No. 77. | October, 1996 |
| Renumbered paragraphs 3.21 and 3.22 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Renumbered paragraph 3.23 (7th bullet) | Added a bullet regarding the communications required by 1994 <i>Government Auditing Standards</i> . | August, 1995 |
| Renumbered paragraph 3.23 | Revised to reflect the issuance of SAS Nos. 78 and 82. | July, 1998 |
| Renumbered paragraph 3.24 | Revised to reflect the issuance of SAS No. 83. | July, 1998 |
| Renumbered paragraph 3.25 | Deleted reference to OMB Circular A-128. | July, 1998 |
| Renumbered paragraph 3.26 | Revised to reflect the issuance of SAS No. 74. | August, 1995 |
| Renumbered paragraph 3.26 | Removed reference to single audit guidance as a result of the issuance of SOP 98-3. | July, 1998 |
| Renumbered paragraph 3.27 | Revised for clarity. | August, 1995 |
| Renumbered paragraph 3.28 | Revised to reflect the issuance of SAS No. 77. | October, 1996 |
| Renumbered paragraph 3.29 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Renumbered paragraph 3.33 | Revised to reflect the issuance of SAS No. 85. | July, 1998 |
| Paragraphs 3.34, 3.35, and 3.36 | Added; Subsequent paragraphs further renumbered. | August, 1995 |
| Renumbered paragraph 3.39 | Revised to reflect the issuance of the revised Audit and Accounting Guide <i>Health Care Organizations</i> . | October, 1996 |
| Renumbered paragraph 3.41 | Revised to reflect the issuance of GASB Statement No. 29 and the revised Audit and Accounting Guide <i>Not-for-Profit Organizations</i> . | October, 1996 |
| Renumbered paragraph 3.44 | Revised to clarify that the paragraph now relates to financial statement audit only. | July, 1998 |
| Renumbered paragraphs 3.45 and 3.46 | Revised to conform to a revision of Ethics Interpretation 101-10. | October, 1996 |
| Paragraph 3.47 | Added to reflect the issuance of Ethics Ruling No. 102. | July, 1998 |
| Chapters 4 and 5 | Revised to reflect the issuance of recent authoritative literature. | July, 1998 |

| <u>Reference</u> | <u>Change</u> | <u>Date</u> |
|-----------------------------------|--|--------------|
| Paragraph 5.20 (footnote *) | Added to reflect the issuance of GASB Statement No. 33. | May, 1999 |
| Paragraph 6.15 | Revised to reflect the issuance of SAS No. 74. | August, 1995 |
| Paragraph 6.25 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Paragraph 6.26 | Revised for clarity. | August, 1995 |
| Paragraph 7.01 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Paragraph 7.02 | Updated references to GASB Codification and revised to reflect the issuance of the GASB Questions and Answers Guides on GASB Statement Nos. 25, 26, 27, and 31. | July, 1998 |
| Paragraph 7.04 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Paragraph 7.08 | Revised to reflect the issuance of GASB Statement No. 31. | July, 1998 |
| Paragraph 7.10 | Updated references to GASB Codification. | July, 1998 |
| Paragraph 7.11 | Revised for clarity. | July, 1998 |
| Paragraph 7.14 | Revised for clarity and to reflect the issuance of GASB Statement No. 31 and GASB Technical Bulletin 97-1; Added references to GASB Codification (final bullet). | July, 1998 |
| Paragraph 7.15 | Revised to reflect the issuance of GASB Statement No. 31 and SAS No. 81. | July, 1998 |
| Paragraph 7.17 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Paragraph 7.18 | Revised to reflect the issuance of SAS No. 78 and the new title of the guide for banks and savings institutions. | July, 1998 |
| Paragraphs 7.19 and 7.20 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Paragraph 7.24 | Revised for clarity. | July, 1998 |
| Paragraph 7.25 | Paragraph added to reflect the issuance of SAS No. 81; Subsequent paragraph renumbered. | July, 1998 |
| Renumbered paragraph 7.26 | Revised the last bullet to reflect the issuance of GASB Statement No. 31. | July, 1998 |
| Chapter 8 (Title) (footnote *) | Added to reflect the issuance of GASB Statement No. 33. | May, 1999 |

| <u>Reference</u> | <u>Change</u> | <u>Date</u> |
|---|---|-------------|
| Paragraphs 8.04 and 8.06 | Revised to update GASB Codification references. | July, 1998 |
| Paragraph 8.10 | Revised to reflect the issuance of GASB Interpretation 5. | July, 1998 |
| Paragraphs 8.11 and 8.12 | Added references to GASB Codification. | July, 1998 |
| Paragraphs 8.17, 8.18, 8.19, 8.20, 8.21, 8.22, 8.23, and 8.24 | Added to reflect the issuance of GASB Statement No. 33; Subsequent paragraphs renumbered. | May, 1999 |
| Renumbered paragraphs 8.28, 8.29, 8.30, and 8.36 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Renumbered paragraph 8.39 | Added references to GASB Codification. | July, 1998 |
| Chapter 9 (Title) (footnote *) | Added to reflect the issuance of GASB Statement No. 33. | May, 1999 |
| Paragraph 9.02 | Revised to reflect the issuance of SOP 98-3. | July, 1998 |
| Paragraphs 9.03 and 9.04 | Revised to update GASB Codification references. | July, 1998 |
| Paragraph 9.07 | Revised to reflect the issuance of SOP 98-2. | July, 1998 |
| Paragraph 9.09 | Added reference to GASB Codification. | July, 1998 |
| Paragraph 9.13 | Added to reflect the issuance of SOP 98-2; Subsequent paragraphs renumbered. | July, 1998 |
| Renumbered paragraphs 9.15 and 9.16 | Revised for additional clarity. | July, 1998 |
| Renumbered paragraph 9.24 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Chapter 10 (Title) (footnote *) | Added to reflect the issuance of GASB Statement No. 33. | May, 1999 |
| Paragraph 10.23 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Paragraph 11.13 | Added reference to GASB Codification. | July, 1998 |
| Paragraph 11.27 | Revised for clarity. | July, 1998 |
| Paragraph 11.29 | Revised to reflect the issuance of GASB Statement No. 33. | May, 1999 |
| Paragraphs 11.31 and 11.32 | Added references to GASB Codification. | July, 1998 |
| Paragraph 11.34 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Paragraphs 12.22 and 12.23 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |

| <u>Reference</u> | <u>Change</u> | <u>Date</u> |
|--|--|---------------|
| Chapter 13 (Title (footnote *)) | Added to reflect the issuance of GASB Statement No. 33. | May, 1999 |
| Paragraph 13.11 | Revised for clarity and added reference to GASB Codification. | July, 1998 |
| Paragraph 13.24 | Revised and footnote added to reflect the issuance of GASB Statement No. 33. | May, 1999 |
| Paragraph 13.25 | Added reference to GASB Codification. | July, 1998 |
| Paragraph 13.30 | Revised for clarity. | July, 1998 |
| Paragraphs 13.32 and 13.33 | Added references to GASB Codification. | July, 1998 |
| Paragraph 13.37 | Revised to reflect the issuance of the revised Audit and Accounting Guide <i>Health Care Organizations</i> . | October, 1996 |
| Paragraphs 13.39, 13.40, 13.41, 13.42, and 13.43 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Paragraph 14.01 | Revised to reflect the issuance of GASB Statement No. 31. | July, 1998 |
| Paragraph 14.03 | Revised to reflect the issuance of GASB Statement No. 32. | July, 1998 |
| Paragraph 14.06 | Added paragraph to reflect the issuance of GASB Statement No. 31; Subsequent paragraphs renumbered. | July, 1998 |
| Renumbered paragraph 14.07 | Revised to reflect the issuance of GASB Statement No. 32. | July, 1998 |
| Renumbered paragraph 14.11 | Revised to reflect that GASB Statement Nos. 25, 26, and 27 are effective. | July, 1998 |
| Paragraph 14.12 | Added paragraph to reflect the issuance of GASB Statement No. 31; Subsequent paragraphs further renumbered. | July, 1998 |
| Renumbered paragraph 14.14 | Revised to reflect the issuance of GASB Statement No. 32. | July, 1998 |
| Renumbered paragraph 14.16 | Revised to reflect the issuance of GASB Statement No. 25. | August, 1995 |
| Renumbered paragraph 14.16 | Revised to reflect that GASB Statement No. 25 is effective. | July, 1998 |
| Paragraph 14.17 | Added paragraph to reflect the issuance of GASB Statement No. 31; Subsequent paragraphs further renumbered. | July, 1998 |
| Renumbered paragraph 14.19 | Revised to reflect the issuance of GASB Statement No. 32. | July, 1998 |

| <u>Reference</u> | <u>Change</u> | <u>Date</u> |
|---|---|---------------|
| Renumbered paragraph 14.19 (footnote *) | Added to reflect revisions to IRC sec. 457. | July, 1998 |
| Renumbered paragraph 14.20 | Revised to reflect the issuance of GASB Statement No. 31. | July, 1998 |
| Renumbered paragraph 14.21 (heading) | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Renumbered paragraph 14.28 | Revised to reflect the issuance of SAS No. 73. | August, 1995 |
| Renumbered paragraphs 14.28 and 14.31 | Revised to reflect the issuance of a new illustrative pension actuarial confirmation request that reflects GASB Statement Nos. 25-27. | July, 1998 |
| Paragraphs 15.13 and 15.14 | Revised to reflect the issuance of SOP 98-2. | July, 1998 |
| Paragraph 15.24 | Added reference to GASB Codification. | July, 1998 |
| Chapter 16 (Title) (footnote *) | Added to reflect the issuance of GASB Statement No. 33. | May, 1999 |
| Paragraph 16.12 | Revised to reflect the issuance of SAS No. 85. | July, 1998 |
| Paragraph 16.14 | Removed reference to single audit as a result of the issuance of SOP 98-3. | July, 1998 |
| Paragraph 16.17 | Revised to reflect the issuance of SAS No. 78. | July, 1998 |
| Paragraph 16.21 | Revised to reflect the change of program name. | July, 1998 |
| Paragraph 16.23 and 16.31 | Added references to GASB Codification. | July, 1998 |
| Paragraph 16.33 | Added paragraph to describe the requirements of GASB Statement No. 24 for food stamps. | July, 1998 |
| Paragraphs 17.02, 17.03, and 17.04 | Revised to reflect the issuance of SAS No. 85 and to be consistent with guidance provided in SOP 98-3. | July, 1998 |
| Paragraph 17.12 | Revised to reflect the issuance of SAS No. 77. | October, 1996 |
| Paragraph 17.14 (footnote *) | Added to reflect the issuance of GASB TB 98-1 and GASB TB 99-1. | May, 1999 |
| Paragraph 17.17 | Added a reference in the 10th bullet to paragraphs 9.13 and 9.14 for additional clarity. | August, 1995 |
| Chapter 18 (Title) (footnote *) | Added to reflect the issuance of GASB TB 98-1 and GASB TB 99-1. | May, 1999 |
| Paragraphs 18.39 and 18.41 | Revised for clarity. | August, 1995 |

| <u>Reference</u> | <u>Change</u> | <u>Date</u> |
|--|--|---------------|
| Paragraphs 18.45 and 18.46 | Added a reference to paragraph 3.12 for additional clarity. | August, 1995 |
| Paragraph 18.48 | Deleted as a result of the issuance of SAS No. 79; Subsequent paragraphs renumbered. | October, 1996 |
| Paragraph 18.55 | Removed reference to single audit as a result of the issuance of SOP 98-3. | July, 1998 |
| Paragraphs 18.57, 18.58, 18.59, 18.60, and 18.61 | Added to make consistent with SOP 98-3. | July, 1998 |
| Paragraph 18.61 | Revised to reflect the issuance of SAS No. 87. | May, 1999 |
| Paragraphs 18.62, 18.63, 18.64, and 18.65 | Added to make consistent with SOP 98-3. | July, 1998 |
| Former paragraph 19.02 | Deleted; Subsequent paragraphs renumbered. | May, 1999 |
| Renumbered Paragraph 19.02 (footnote *) | Added to reflect the issuance of an SEC interpretation. | May, 1999 |
| Renumbered paragraph 19.08 | Revised to reflect the issuance of SAS Nos. 75 and 76, and SSAE No. 4. | October, 1996 |
| Chapters 20, 21, 22, 23, and 24 | Deleted as a result of the issuance of SOP 98-3. | July, 1998 |
| Appendix A | Revised to reflect the issuance of SOP 98-3. | July, 1998 |
| Appendix A | Revised to reflect the issuance of SAS No. 87. | May, 1999 |
| Appendix B | Revised to reflect the issuance of recent authoritative literature. | May, 1999 |
| Appendixes C, D, E, F, G, H, and I | Deleted as a result of the issuance of SOP 98-3. | July, 1998 |
| Appendix J | Revised. | July, 1998 |
| Appendix K | Revised to reflect the changes made in AICPA <i>Professional Standards</i> . | July, 1998 |
| Appendix L | SOP 98-2 added. | June, 1998 |
| Appendix M | SOP 98-3 added. | June, 1998 |
| Appendix M | Revised to reflect the issuance of SAS No. 87. | May, 1999 |
| Appendix N | Added illustrative pension actuary confirmation request. | July, 1998 |

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