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Joseph F. Moraglio

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A I C P A P r a c t i c e A i d S e r i e s

**Auditing Recipients of
Federal Awards: Practical Guidance
for Applying OMB Circular A-133,
*Audits of States, Local Governments,
and Non-Profit Organizations***

S E C O N D E D I T I O N

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Notice to Readers

Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, presents the views of the author and others who helped in its development. This publication has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the American Institute of Certified Public Accountants. Therefore, the contents of this publication, including recommendations and suggestions, have no official or authoritative status.

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Written by
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Edited by
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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

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Acknowledgments

Many people contributed to the development of this practice guide. We gratefully acknowledge the significant contribution of Deborah A. Koebele, who edited this edition. In addition, we acknowledge and thank these members of the review team for the value they added to this edition of the practice aid: Marcia B. Buchanan, Mary M. Foelster, Jill R. O'Brien, Terrill W. Ramsey, and Venita M. Wood.

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Preface

The publications that constitute the AICPA Practice Aid Series have been designed to address a broad range of topics that affect today's CPA. From enhancing the efficiency of your practice to developing the new skill sets required for a successful transition to meet the challenges of the new millennium, this series provides practical guidance and information to assist in making sense out of a changing and complex business environment. The talents of many skilled professionals have been brought together to produce what we believe will be valuable additions to your professional library.

This practice guide has been published to provide auditors of states, local governments, and not-for-profit organizations that receive federal awards with nonauthoritative practical guidance on auditing and reporting on single audits and program-specific audits under the following:

- The Single Audit Act Amendments of 1996
- Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*
- The 1994 revision of *Government Auditing Standards*, as amended (also referred to as the Yellow Book or GAS), issued by the Comptroller General of the United States of the U.S. General Accounting Office (GAO). *Government Auditing Standards* incorporate generally accepted auditing standards (GAAS) issued by the American Institute of Certified Public Accountants (AICPA)¹
- Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*

Chapter 1 of this practice guide presents and discusses the contents of OMB Circular A-133, and chapter 2 presents and discusses the contents of the A-133 *Compliance Supplement*, respectively. Chapter 3 discusses issues relating to procuring audit services for an A-133 audit. Chapter 4 discusses the planning of the single audit and the selection of major programs using the A-133-mandated risk-based approach. Chapter 5 discusses audit procedures relating to internal control, and chapter 6 discusses audit procedures relating to compliance. Chapter 7 discusses the reporting requirements for a single audit, and chapter 8 discusses the A-133 requirements for conducting and reporting on a program-specific audit. Where applicable, this practice guide refers the reader to additional guidance in GAAS, *Government Auditing Standards*, and SOP 98-3.

The Practice Aids, including a comprehensive case study, referred to throughout this text appear in the companion portion—Practice Aids—of this guide. This separate treatment is designed to make it easier for auditors to use the Practice Aids on audits.

¹ Generally accepted auditing standards requirements are discussed in the practice guide to the extent that they are necessary to explain the related requirements of *Government Auditing Standards*. Auditors should refer to relevant AICPA Audit and Accounting Guides, such as *Not-for-Profit Organizations*, *Health Care Organizations*, and *Audits of State and Local Governmental Units*, which includes Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, for additional information. Contact the AICPA at (888) 777-7077 to obtain these publications.

CHAPTER 1: OMB Circular A-133: *Audits of States, Local Governments, and Non-Profit Organizations*

On June 30, 1997, the Office of Management and Budget (OMB) issued Circular A-133 (A-133) to implement the provisions of the Single Audit Act Amendments of 1996 (1996 Amendments). This chapter presents a digest of the provisions of A-133 and refers users to other chapters in this practice guide where those provisions are discussed in more detail. The 1996 Amendments are included as appendix A and A-133 is included as appendix B of this part of the practice guide; they also may be obtained from the sources indicated in the appendix to the Practice Aids¹ portion of this practice guide.

BACKGROUND

A-133 sets forth standards for obtaining consistency and uniformity for audits of states, local governments, and not-for-profit organizations that expend federal awards. Those standards also apply to Indian tribal governments, which A-133 defines and classifies as states. A-133 rescinds OMB Circular A-128, *Audits of State and Local Governments*, issued April 12, 1985, and supersedes OMB Circular A-133, *Audits of Institutions of Higher Education and Other Non-Profit Institutions*, issued April 22, 1996.

This combination of requirements into a single circular was intended to minimize confusion for auditees and auditors and to provide uniform audit requirements for non-federal entities that administer federal awards.

Because OMB Circulars apply to federal agencies, federal agencies implement them through regulations. A-133 required that federal agencies adopt its provisions in codified regulations no later than August 29, 1997. A-133 uses the “common rule” format so the various agencies implementing the regulations use the same paragraph numbers for each requirement. The prefix before the paragraph number identifies the federal agency.

If OMB had not used the common rule approach, federal agencies may have issued their regulations using different formats or words, or both. Auditors who perform audits in accordance with A-133 find it easy to locate specific paragraphs in an agency’s implementing regulations because each agency uses the corresponding paragraph numbers that appear in A-133. For example, each federal agency uses paragraph .500 for Scope of Audit, preceded by its identifying Code of Federal Register (CFR) number.

The requirements of A-133 must be applied by all federal agencies unless an applicable statute is specifically different. In that case, the statute’s provisions govern. Further, A-133 requirements apply to both direct recipients and subrecipients. However, they do not apply to for-profit or non-U.S.-based entities expending federal awards received directly or indirectly.

If auditors need additional information or have questions about A-133, they should contact the recipient entity’s cognizant or oversight agency for audit, or federal funding agency, as appropriate, or the subrecipient entity’s pass-through entity. A listing of agency contacts is included as appendix III, “Federal Agency Contacts for A-133 Audits,” in OMB Circular A-133 *Compliance Supplement (Compliance Supplement)*.

¹ The Practice Aids referred to throughout this guide correspond to checklists, exhibits, and other illustrations related to the respective topics being discussed and appear in a separate portion of this publication.

OVERVIEW

OMB Circular A-133 established a uniform system for the single audits of state and local governments, institutions of higher education, and other not-for-profit organizations and implemented the 1996 Amendments. The provisions of A-133 of significance to auditors include the following:

- Setting the threshold for when states, local governments, and not-for-profit organizations are required to have a federally mandated audit at \$300,000 expended (§ _____.200)
- Requiring auditees to prepare annual financial statements that reflect their financial position, results of operations, or changes in net assets and, where appropriate, cash flows. With certain exceptions, the financial statements should be for the same organizational unit as covered by the single audit (§ _____.310(a))
- Providing guidance for conducting program-specific audits (§ _____.235), reporting audit findings (§ _____.510), and following up on audit findings (§ _____.315)
- Setting the audit reporting submission due date at nine months after year end (§ _____.320)
- Adopting a risk-based approach for determining major programs to be tested, except that certain “first-year” audits may use a dollar threshold (§ _____.520)
- Requiring that programs selected as major cover 50 percent of federal awards expended (§ _____.520(f)) (If the auditee meets the criteria in § _____.530 for a low-risk auditee, reduced coverage [25 percent] is permitted.)
- Requiring the auditor’s reports to include (§ _____.505)—
 - An opinion (or disclaimer of opinion) on the auditee’s financial statements and schedule of expenditures of federal awards
 - Reporting on internal control related to the financial statements and major programs
 - Reporting on compliance related to the financial statements
 - An opinion (or disclaimer of opinion) on compliance related to each major program
 - A schedule of findings and questioned costs, including a summary of auditor’s results, findings related to the financial statements, and findings and questioned costs for federal awards
- Requiring the submission of a data collection form (§ _____.320(b))
- Requiring planning and testing of internal control over compliance related to major federal programs to support a low assessed level of control risk (§ _____.500(c))
- Prohibiting the firm that prepares the indirect cost proposal or cost allocation plan from performing the audit when indirect costs recovered during the prior year exceed \$1 million (§ _____.305(b))
- Requiring the auditor to assess the reasonableness of management’s representations in the schedule of the status of prior audit findings (§ _____.500(e))

A-133 includes five subparts, each providing regulations its own category and using paragraphs with a specific series number, as follows:

- A, general, .100
- B, audits, .200
- C, auditees, .300
- D, federal agencies, .400
- E, pass-through entities, .500

DEFINITIONS (§____.105)

This section includes definitions that are essential to an understanding of A-133. This chapter incorporates those definitions as appropriate in the following discussion.

AUDIT REQUIREMENTS (§____.200)

An audit is mandated based on an auditee's annual expenditure of federal awards rather than the amount of federal financial assistance received. The level of such expenditures that invokes the requirement for a single or program-specific audit is \$300,000. If annual expenditures of federal awards are less than this amount, the A-133 audit requirements do not apply.

The term *federal awards* includes both direct and indirect awards but does not include federal procurement contracts, under grants or contracts, that are used to buy goods or services from vendors. *Federal awards* include both federal cost-reimbursement contracts and federal financial assistance. Federal financial assistance is assistance received or administered in the form of—

- Grants.
- Cooperative agreements.
- Direct appropriations.
- Loans and loan guarantees.
- Property (including donated surplus property).
- Food commodities.
- Interest subsidies.
- Insurance.
- Other assistance.

Definitions of different types of federal financial assistance, taken from the Catalog of Federal Domestic Assistance (CFDA),² are shown in exhibit 2-1.

Federal financial assistance generally does not include amounts received as reimbursement for patient care services rendered to Medicare- and Medicaid-eligible individuals. (See discussion of §____.205, below.)

A-133 requires auditees to prepare a schedule of expenditures of federal awards and auditors to select major programs based on A-133's definition in §____.105 of *federal programs*. Federal programs are the following, unless they are part of a cluster:

1. All federal awards assigned a single number in the CFDA
2. When no CFDA number is assigned, all federal awards from the same agency for the same purpose

A cluster of programs is "a grouping of closely related programs that share common compliance requirements." Clusters are research and development (R&D), student financial assistance, and other clusters as defined in Part 5, "Clusters of Programs," in the *Compliance Supplement*. Other clusters also may be designated by a state for federal awards provided to subrecipients. The OMB-designated program clusters and the CFDA numbers of the programs that are included in those clusters are listed in Part 5 of the *Compliance Supplement*.

² The CFDA is a government-wide compendium of federal programs, projects, services, and activities that provide assistance or benefits to the American public. The CFDA may be obtained from the sources indicated in the appendix to the Practice Aids portion of this practice guide.

Single Audits

The auditee may elect to have a single audit of the entire entity or a series of audits of the parts of the entity that expend federal awards. Criteria for a series of audits are in §____.310 of A-133 and discussed in chapter 4 of this practice guide. The scope and reporting requirements of a single audit are in §____.500 and discussed in chapters 4 through 7 of this practice guide.

Program-Specific Audits

If the auditee expends federal funds from only one federal program and meets the other requirements set forth in §____.200(c), which relate to R&D programs and to potential requirements for a financial statement audit, the auditee may elect a program-specific audit conducted in accordance with §____.235. See chapter 8 of this practice guide for guidance on conducting a program-specific audit.

Federally Funded Research and Development Center

A federally funded research and development center (FFRDC) may elect to be treated as a separate entity for purposes of conducting an audit in accordance with A-133.

BASIS FOR DETERMINING FEDERAL AWARDS EXPENDED (§____.205)

It is important to determine when a federal award is expended because those expenditures serve as the basis for determining when an A-133 audit is required, the information on the schedule of expenditures of federal awards, and major programs. The determination of when an award is expended should be based on when the activities that require compliance with laws, regulations, and the provisions of contracts or grant agreements take place. When such activities take place is summarized as follows:

FEDERAL AWARDS	BASIS FOR DETERMINING WHEN EXPENDED ³
1. Grants, cost reimbursement contracts, cooperative agreements, and direct appropriations	1. When the expenditure or expense transactions occur
2. Amounts passed through to subrecipients	2. When the disbursement is made to the subrecipient
3. Loan and loan guarantees	3. When the loan proceeds are used (See the further discussion on loans and loan guarantees in the following section.)
4. Property, including donated surplus property	4. When the property is received
5. Food commodities	5. When the food commodities are distributed or consumed
6. Interest subsidies	6. When amounts are disbursed entitling the entity to the subsidy
7. Insurance	7. When the insurance is in force
8. Program income	8. When received and used

³ Auditors and auditees should note that the definition of when an award is expended under A-133 may differ from the GAAP requirement for expenditure recognition for the same transaction. For example, GASB standards do not include provisions related to the recognition of expenditures for loan programs and GAAP do not recognize expenditures for the balance of loans from previous years.

Loans and Loan Guarantees

In many situations, the expenditures for loans and loan guarantees should be measured based on the balance of loans from previous years for which the federal government imposes continuing compliance requirements as well as any interest, cash, or administrative cost allowances received. See §____.205(b), (c), and (d) of A-133 and exhibit 6-2 of this practice guide for specific requirements, including those applicable to loans and loan guarantees at institutions of higher education. In addition, §____.205(j) indicates that certain loans made by the National Credit Union Administration are not considered federal awards.

Endowment Funds

The cumulative balance of federally restricted endowment funds are considered awards expended in each year in which the funds are still restricted.

Noncash Assistance

Free rent generally is not considered a federal award. However, when free rent is part of an award to carry out a federal program, it is included in determining federal awards expended. Free rent and other noncash assistance, such as food stamps, commodities, and donated property, should be valued based on the fair value at the time of receipt or the assessed value provided by the federal agency. Exhibit 6-2 of this practice guide discusses the basis for determining federal expenditures for noncash assistance.

Medicare and Medicaid

Medicare payments for patient care services to individuals are not considered federal awards under A-133. Medicaid payments to a subrecipient for such services are not considered federal awards to that subrecipient unless a state requires it. However, the federal awards expended by a state that passes Medicaid funds through to subrecipients are considered federal awards under A-133.

SUBRECIPIENT AND VENDOR DETERMINATION (§____.210)

A-133 provides guidance in §____.210(a) through (d) for determining whether an entity is a subrecipient or vendor. Payments received by vendors for goods or services are not considered federal awards for purposes of A-133. See chapter 4 of this practice guide for a discussion of this guidance and of the following requirements related to for-profit subrecipients and vendors.

For-Profit Subrecipients

Because A-133 does not apply to for-profit entities, pass-through entities are responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients.

Vendor

Program compliance requirements normally do not pass through to a vendor. However, there may be situations in which the auditee should ensure compliance for vendor contracts or when the scope of the A-133 audit should include vendor transactions. Refer to §____.210(f) for a discussion of these situations.

RELATION TO OTHER AUDIT REQUIREMENTS (§____.215)

The audit conducted in accordance with A-133 is in lieu of any other financial audit required by individual federal awards. Federal agencies are required to rely on and use A-133 audits to the extent it meets their needs. Additional audits may be conducted, but the federal agency requesting such audits must pay for them.

Federal agencies also may request, at least 180 days before year end, that a program be audited as a major program. The auditee should consult with the auditor to determine whether that program will be audited as a major program and notify the agency. If the program would not be audited as a major program and the federal agency wants it so audited, the federal agency must pay for the incremental costs of the audit. A pass-through entity also may use the provisions of this paragraph for a subrecipient.

FREQUENCY OF AUDITS (§____.220)

Audits are to be conducted annually, except biennial audits, which are permitted as follows:

<u>ENTITY</u>	<u>BIENNIAL AUDIT PERMITTED IF</u>
State or local government	A legal requirement for such audits was in effect on January 1, 1987, and is still in effect
Not-for-profit organization	A biennial audit was conducted for all biennial periods between July 1, 1992 and January 1, 1995

SANCTIONS (§____.225)

No cost of an A-133 audit may be charged to federal awards if the audit was not required by A-133 or did not comply with A-133. Sanctions also can be imposed when the auditee does not or cannot have an audit conducted in accordance with A-133.

AUDIT COSTS (§____.230)

Guidance on the allowability of audit costs is provided in §____.230. Generally, costs of A-133-required audits are allowable charges.

A-133 does not permit a non-federal entity to charge the cost of an audit to federal programs if it was not conducted in accordance with A-133. Specifically, if a non-federal entity expends less than \$300,000 a year—and, thus, is exempt from having an A-133 audit—the cost of any audit of that entity is not chargeable to federal programs. However, A-133 allows a pass-through entity to charge federal programs for the cost of limited-scope audits to monitor its subrecipients, provided the subrecipient does not have a single audit. For this purpose, limited-scope audits include only agreed-upon procedures engagements conducted in accordance with either generally accepted auditing standards (GAAS) or the 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, and earmarking; and reporting.

PROGRAM-SPECIFIC AUDITS (§____.235)

There are different requirements for performing and reporting on a program-specific audit depending on the availability of a program-specific audit guide. Those requirements are discussed in chapter 8 of this practice guide.

AUDITEE RESPONSIBILITIES (§____.300)

A-133 imposes a number of requirements on the auditee, including the following:

- Maintaining books and records that identify federal programs and awards received and expended

- Maintaining internal control to ensure compliance with the laws, regulations, and provisions of contracts or grant agreements that could have a material effect on each of its federal programs
- Complying with the laws, regulations, and provisions of contracts or grant agreements related to each of its federal programs (See also §____.210(e) and (f) for an auditee’s responsibilities for compliance requirements related to for-profit subrecipients and vendors.)
- Preparing financial statements, including the schedule of expenditures of federal awards
- Arranging for the required audit, including the following:
 - Engaging an auditor using the applicable procurement standards (§____.305)
 - Ensuring that the required audits are properly performed and submitted when due. If auditees receive an extension to the report submission due date from the cognizant or oversight agency for audit, they are required to notify the federal clearinghouse and each pass-through entity of the extension
 - Following up and taking corrective action on audit findings, including the following:
 - (1) Preparing a summary schedule of prior audit findings
 - (2) Preparing a corrective action plan
 - Submitting the appropriate number of audit reports on a timely basis to the federal clearinghouse and to each pass-through entity (§____.320)
 - Submitting a data collection form (§____.320)
 - Responding to requests by federal agencies and pass-through entities for copies of the reporting package and management letters (§____.320)
 - Retaining one copy of the required reporting package for three years (§____.320)

These auditee responsibilities are discussed in chapters 3 through 7 of this practice guide.

In addition, pass-through entities have certain responsibilities for the federal awards they make to subrecipients. See §____.400, below.

AUDITOR SELECTION (§____.305)

Auditor Procurement

In arranging for audit services, the auditee is to follow the applicable procurement standards prescribed by the following:

- Circular A-102, Grants Management Common Rule, *Uniform Administrative Requirements for Grants and Cooperative Agreements with State and Local Governments (A-102 Common Rule)*
- Circular A-110, *Uniform Requirements for Grants and Agreement with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations*
- Federal Acquisition Regulation (48 CFR part 42)

A copy of those documents may be obtained from the sources indicated in the appendix to the Practice Aids portion of this practice guide.

Restriction on the Auditor Preparing the Indirect Cost Proposal

If the auditee recovers more than \$1 million of indirect costs during the prior year, the firm that prepares the indirect cost proposal or cost allocation plan may not perform the audit during the base year or any subsequent year in which that agreement or plan is used to recover indirect costs. This restriction is discussed more fully in chapter 3 of this practice guide.

FINANCIAL STATEMENTS (§____.310)

The financial statements are set forth in §____.310(a) and the minimum contents of the schedule of expenditures of federal awards are set forth in §____.310(b), and they are discussed in chapter 7 of this practice guide.

AUDIT FINDINGS FOLLOW-UP (§____.315)

The form and content of the summary schedule of prior audit findings are set forth in §____.315(b) and the form and content of the corrective action plan are set forth in §____.315(c), and they are discussed and illustrated in chapter 7 of this practice guide.

REPORT SUBMISSION (§____.320)

The audit should be completed and the required reporting package and data collection form submitted to the federal clearinghouse within nine months after the end of the audit period, unless an extension has been granted by the cognizant or oversight agency for audit.

The reporting package includes the following:

1. Financial statements and schedule of expenditures of federal awards
2. Summary schedule of prior audit findings
3. Auditor's reports
4. Corrective action plan

The data collection form is an OMB-approved form that requires information about whether the audit was completed in accordance with A-133 and about the auditee, its federal programs, and the results of the audit. The form provides this information in a consistent format so the federal clearinghouse can enter the information into a database. The form also requires the identification of those federal agencies providing direct federal assistance for which there are current- or prior-year audit findings, thereby allowing the clearinghouse to forward copies of the reporting package to those agencies.

In addition, §____.320 addresses the following:

- The number of copies of the reporting package to be submitted to the federal clearinghouse
- Additional submissions by subrecipients to pass-through entities
- Requests for copies of reports and management letters by federal agencies and pass-through entities
- Report retention requirements
- Clearinghouse responsibilities
- Clearinghouse address

These reporting requirements are discussed in chapter 7 of this practice guide.

FEDERAL AGENCIES' AND PASS-THROUGH ENTITIES' RESPONSIBILITIES (§____.400)

The responsibilities of these agencies and entities are subdivided into those of—

1. Cognizant agency for audit (§____.400(a)).
2. Oversight agency for audit (§____.400(b)).
3. Federal awarding agency (§____.400(c)).

4. Pass-through entity (§____.400(d)).

A-133 establishes a process for identifying cognizant and oversight agencies for audit that generally can be implemented without OMB involvement. Entities expending more than \$25 million a year will have a cognizant agency for audit. The cognizant agency for audit is the federal awarding agency that provides the predominant amount of direct funding (that is, the largest amount of direct federal awards expended), unless the OMB makes a specific designation. The determination of the predominant amount of direct funding is made every five years, rather than every year, as follows:

AUDIT COGNIZANT DETERMINATION YEAR	AUDIT COGNIZANT SERVICE YEARS
1995	1997–2000
2000	2001–2005
2005	2006–2010
Every five years thereafter	For the five following years

For state and local governments that previously have been assigned a cognizant agency for audit, the change to a new cognizant took effect for fiscal years beginning after June 30, 2000.

Entities expending \$25 million or less a year will have an oversight agency for audit. The oversight agency is the federal agency that provides the predominant amount of direct funding to the entity, even though another agency may provide more indirect funding. (For example, a school district may receive its only direct funding from the U.S. Department of Agriculture [USDA] under the Food Distribution [commodities] program, CFDA number 10.550. In this case, USDA is the district’s oversight entity, even though the U.S. Department of Education provides a much larger amount of indirect funding through the state’s Department of Education.) If there is no direct funding, the oversight agency for audit is the federal agency that provides the predominant amount of indirect funding.

The responsibilities of cognizant and oversight agencies for audit are as follows:

	COGNIZANT AGENCY FOR AUDIT	OVERSIGHT AGENCY FOR AUDIT
1. Provide technical advice and liaison to auditees and auditors	✓	✓
2. Grant extensions to the report submission due date for good cause	✓	May assume
3. Obtain or conduct quality control reviews	✓	May assume
4. Promptly inform other affected agencies and law enforcement officials of reported irregularities or illegal acts	✓	May assume
5. Advise the auditor when deficiencies are found in the audit and follow-up on corrective action	✓	May assume
6. Coordinate additional audits and reviews	✓	May assume
7. Coordinate a management decision for audit findings affecting the programs of more than one agency	✓	May assume
8. Coordinate the audit work and reporting responsibilities	✓	May assume
9. For biennial audits, consider auditee request to qualify as a low-risk auditee	✓	May assume

The responsibilities of federal awarding agencies and pass-through entities are as follows:

	FEDERAL AWARDING AGENCY	PASS-THROUGH ENTITY
1. Identify and provide information about federal award	✓	✓
2. Advise recipients or subrecipients of compliance requirements	✓	✓
3. Ensure that required audits are appropriately and timely completed	✓	✓
4. Provide technical advice and counsel to auditees and auditors	✓	N/A
5. Issue a management decision within six months and ensure that recipients take appropriate and timely corrective action	✓	✓
6. Assign a person for providing annual updates of the compliance supplement to OMB	✓	N/A
7. Monitor the activities of subrecipients to ensure compliance and that performance goals are achieved	N/A	✓
8. Consider whether subrecipient audits make the adjustment of pass-through entity's own records necessary	N/A	✓
9. Require subrecipients to permit the pass-through entity and auditors access to their records to comply with A-133	N/A	✓

These responsibilities—as they relate to an auditee—are discussed in chapter 4 of this practice guide.

MANAGEMENT DECISION (§____.405)

Management decisions that are coordinated or issued by a federal agency or issued by a pass-through entity should be issued within six months of receipt of the audit report and state:

1. Whether the audit finding is sustained.
2. Reason for the decision.
3. Expected auditee action to—
 - a. Repay disallowed costs.
 - b. Make financial adjustments.
 - c. Take other action.
4. Any appeal process available to the auditee.

Corrective action should be initiated within six months after receipt of the audit report and proceed as rapidly as possible. Before issuing a management decision, the federal agency or pass-through entity may request additional information from the auditee or its auditor. If the auditee has not completed corrective action, A-133 provides for the auditee to provide a timetable for follow-up.

SCOPE OF AUDIT AND REPORTING (§ _____.500 AND § _____.505)

Exhibit 1-2 is a summary of audit and reporting requirements for single audits. (See chapter 8 for a discussion of audit and reporting requirements for program-specific audits.) The *Compliance Supplement* includes the compliance requirements for various federal programs. However, auditors should note that § _____.500(d) indicates that, where there have been changes to the compliance requirements and the changes are not reflected in the *Compliance Supplement*, auditors are required to determine the current compliance requirements and modify the audit procedures accordingly. For those federal programs not covered in the *Compliance Supplement*, auditors should use the types of compliance requirements contained in the *Compliance Supplement* to guide them in identifying the types of compliance requirements to test and should determine the requirements governing the federal program by reviewing applicable laws, regulations, and contracts and grant agreements. Part 7 of the *Compliance Supplement* includes further guidance on auditing programs that are not included in the *Compliance Supplement*. Use of the *Compliance Supplement* is further discussed in chapters 2, 5, and 6 and illustrated in a case study in the Practice Aids portion of this practice guide.

AUDIT FINDINGS (§ _____.510)

§ _____.510, sets forth what is to be included as audit findings in the schedule of findings and questioned costs. Audit findings are to include—

- Reportable conditions in internal control over major programs. (Reportable conditions for this purpose are in relation to a type of compliance requirement or an audit objective identified in the *Compliance Supplement*)
- Material noncompliance with laws, regulations, and the provisions of contracts or grant agreements related to major programs. (Material noncompliance for this purpose is in relation to a type of compliance requirement 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.
- Known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program.
- Known questioned costs greater than \$10,000 for a program that is not audited as major.
- If not otherwise reported in the schedule of findings and questioned costs, circumstances concerning why a qualified, disclaimed, or adverse opinion is issued on compliance for major programs.
- Known fraud affecting a federal award, unless previously reported outside of the auditor's reports under the direct reporting requirements of *Government Auditing Standards* (GAS).
- Material misrepresentations by management as to the status of any prior audit findings.

A-133 requires the following specific information to be included, as applicable, when reporting audit findings:

1. Identification of the federal program and specific federal award, including CFDA number and title, federal award number and year, and names of federal awarding agency and pass-through entity
2. Criteria or specific requirement upon which the finding is based, including statutory or regulatory citations
3. Condition found and facts surrounding it
4. Questioned costs and how computed
5. Information to provide proper perspective for judging the prevalence and consequence of the audit findings
6. Sufficient information to determine cause and effect

7. Recommendations to prevent future occurrence of the deficiency identified in the finding
8. Views of responsible officials when they disagree with the finding, if practical

A reference number should be included for each finding to allow for future referencing. One approach is to use the year and the finding number, for example "05-1," for finding number one for the fiscal year 2005 audit.

Audit findings are discussed in chapter 7 of this practice guide. They also are illustrated in Single Audit Case Study Practice Aid of the Practice Aid portion of this guide.

RETENTION OF AND PROVIDING ACCESS TO AUDIT WORKING PAPERS (§ _____.515)

A-133 requires auditors to retain working papers and reports for a minimum of three years after the date of issuance of the auditor's reports unless notified in writing by an authorized entity to extend the retention period. If the auditor is aware that a finding is being contested, the auditor is required to contact the contesting parties before destroying the working papers.

Access to the auditor's working papers is to be provided to the cognizant or oversight agency for audit, the federal funding agency, and the General Accounting Office (GAO). Access to auditor's working papers includes the right of those agencies to obtain copies.

MAJOR PROGRAM DETERMINATION (§ _____.520) AND CRITERIA FOR FEDERAL PROGRAM RISK (§ _____.525)

§ _____.520 sets forth guidance for the auditor for determining major programs, including the requirement to perform risk assessments on certain federal programs. Those requirements are discussed in chapter 4 of this practice guide and illustrated in a case study in the Practice Aid portion of this practice guide. In general, the auditor should use a risk-based approach to determine which federal programs are major programs. Generally, the auditor should audit as major programs federal programs that in the aggregate encompass at least 50 percent of the total federal expenditures. However, OMB has reduced audit coverage for entities that qualify as low-risk auditees. Specifically, for low-risk auditees, auditors need only audit as major programs federal programs that in the aggregate encompass at least 25 percent of total federal expenditures. § _____.530 establishes the criteria for qualifying as a low-risk auditee.

Documentation of Risk and Auditor's Judgment

The risk analysis process used in determining major programs should be documented in the working papers. When the major program determination is performed and documented in accordance with the established requirements, the auditor's judgment will be presumed correct.

First-Year Audits

The auditor may use dollar thresholds to determine major programs rather than a risk-based approach for first-year audits. First-year audits include the first year the entity is audited under A-133 and the first year of a change of auditors. The election for a first-year audit may not be used more often than once every three years.

Risk Assessments

The criteria for performing risk assessments for federal programs are set forth in § _____.525 and include—

1. Overall evaluation of the risk of material noncompliance.

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

LOW-RISK AUDITEES (§ _____.530)

§ _____.530 established the criteria that an auditee should meet to be considered a low-risk auditee and thus qualify for a lowered percentage-of-coverage requirement, as discussed above, in § _____.520. To be a low-risk auditee, an entity must meet all of the following conditions for the preceding two audit periods:

- Single audits performed
- Unqualified opinions on the financial statements and the schedule of expenditures of federal awards, unless the federal cognizant or oversight agency for audit has provided a waiver
- No material weaknesses in internal control at the financial statement level, unless the federal cognizant or oversight agency for audit provides a waiver
- No audit findings of certain types for programs classified as Type A

A low-risk auditee can be an entity that receives either annual or biennial audits. An entity that has biennial audits does not qualify as a low-risk auditee unless agreed to in advance by the cognizant or oversight agency for audit. For other auditees, the single audits for the prior two fiscal years have to have been performed on an annual basis.

The criteria for classification of an auditee as low-risk are discussed in detail in chapter 4.

EXHIBIT 1-1 • TYPES OF FEDERAL ASSISTANCE

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. Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, describes the eight principal types of assistance that are available as follows:

Formula grants: Allocations of money to non-federal entities that are made in accordance with a distribution formula prescribed by law or administrative regulation, for activities of a continuing nature not confined to a specific project. 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: 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 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 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 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: Programs in which 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 provided to ensure 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: Programs that provide for the sale, exchange, or donation of federal real property, personal property, commodities, and other goods, including land, buildings, equipment, food, and drugs. This does not include the loan of, use of, or access to federal facilities or property.

EXHIBIT 1-2 SUMMARY OF A-133: AUDIT AND REPORTING REQUIREMENTS FOR SINGLE AUDITS

<i>Requirement</i>	<i>Audit Work</i>	<i>Reporting Requirements*</i>
1. General		
a. Auditing standards and reporting requirements to be followed	a. GAAS, GAS, and A-133	a. GAAS, GAS, and A-133
b. Entity to be covered	b. Entire operation or a series of audits of components	b. Entire operation or a series of reports of components
2. Financial statements		
a. Financial statements	a. Determine whether the financial statements are fairly presented in all material respects in conformity with GAAP	a. An auditor opinion (or disclaimer of opinion) on the financial statements
b. Schedule of expenditures of federal awards	b. Determine whether the schedule is fairly presented in all material respects in relation to the financial statements	b. An auditor opinion (or disclaimer of opinion) on the schedule in relation to the financial statements taken as a whole
3. Internal control		
a. Financial statement level	a. As required by GAAS and GAS, obtain a sufficient understanding of internal control over financial reporting and compliance to plan the audit and to determine the nature, timing, and extent of the tests to be performed** See also chapter 5 of this guide for an additional field work standard from GAS relating to documentation.	a. As required by GAS, a report on internal control related to the financial statements. (No opinion is required.) The report is to include the scope of testing performed and results. (Where applicable, A-133 requires a reference to the separate schedule of findings and questioned costs)
b. Federal awards level	b. As required by A-133, obtain an understanding of internal control over federal programs to support a low assessed level of control risk for major programs. Plan and perform tests of internal control over major programs, unless such internal control is likely to be ineffective. If control is likely to be ineffective, consider whether additional compliance tests are required.	b. As required by A-133, a report on internal control related to major programs. (No opinion is required.) The report is to include the scope of testing performed and results. (Report a reportable condition or material weakness if the internal control is likely to be ineffective.) (Where applicable, refer to the separate schedule of findings and questioned costs.)
4. Compliance		
a. Financial statement level	a. As required by GAS, design the audit to provide reasonable assurance of detecting non-compliance with the laws, regulations, and provisions of contracts and grant agreements that could have a direct and material affect on the determination of financial statement amounts**	a. As required by GAS, a report on compliance at the financial statement level and results of tests. (No opinion is required.) (Where applicable, A-133 requires a reference to the separate schedule of findings and questioned costs.)
b. Federal awards level	b. As required by A-133, perform sufficient compliance testing of transactions and other auditing procedures to support an opinion on	b. As required by A-133, an opinion (or disclaimer of opinion) on compliance relative to each major program. (Where

EXHIBIT 1-2 SUMMARY OF A-133: AUDIT AND REPORTING REQUIREMENTS FOR SINGLE AUDITS (continued)

- | | | |
|---|--|--|
| <p>c. Findings and questioned costs</p> | <p>whether the auditee has complied with the laws, regulations, and provisions of contracts or grant agreements that could have a direct and material effect on each of its major programs and material effect on each of its major programs</p> <p>c. As required by GAS and A-133, audit work related to the audit of the financial statements and testing of federal awards</p> | <p>applicable, refer to the separate schedule of findings and questioned costs.)</p> <p>c. As required by A-133, the schedule of findings and questioned costs should include:</p> <ul style="list-style-type: none"> (1) A summary of the auditor's results (2) Findings related to the financial statements as required by GAS (3) Findings and questions costs related to federal awards <p>See chapter 7 for a detailed discussion of this schedule and its elements.</p> |
| <p>5. Audit follow-up</p> <p>a. Financial statement level</p> | <p>a. As required by GAS, follow up on known material findings and recommendations from previous audits</p> | <p>a. As required by GAS, report the status of material findings and recommendations from prior audits that affect the current financial statement audit</p> |
| <p>b. Federal awards level</p> | <p>b. As required by A-133, follow up on prior audit findings and perform procedures to assess the reasonableness of the auditee's summary schedule of prior audit findings</p> | <p>b. As required by A-133, report when the auditor concludes that the status of a prior audit finding is materially misrepresented</p> |

* Certain illustrative auditor's reports, taken from Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, are included in the Practice Aids portion of this practice guide.

** GAS also requires auditors to communicate information to certain parties during the planning stages of an audit regarding the nature and extent of planned testing and reporting on compliance with laws and regulations and on internal control over financial reporting.

CHAPTER 2: *Compliance Supplement*

This chapter discusses the structure, content, and use of OMB Circular A-133 *Compliance Supplement* (*Compliance Supplement*), which may be obtained from the sources indicated in the appendix to the Practice Aids portion of this practice guide. You can copy and use the electronic versions available on the Internet to develop audit programs. The use of the *Compliance Supplement* is discussed in chapters 4 through 6 and illustrated in the Single Audit Case Study Practice Aid located in the Practice Aids portion of this guide.

OVERVIEW

The *Compliance Supplement* is revised and issued annually (generally in the spring) and should be used in single audits conducted in accordance with Circular A-133 (A-133). Each revision of the *Compliance Supplement* contains an effective date for its use in single audits. In addition, the revision reflects changes in the compliance requirements for the federal programs it includes as well as the addition of programs not previously included. For single audits, the *Compliance Supplement* also replaces agency audit guides and other audit requirement documents for individual federal programs. (See chapter 8 of this practice guide for a discussion of the appropriate guidance to use for program-specific audits.)

The *Compliance Supplement* has the following parts and appendixes:

- Part 1 Background, Purpose, and Applicability
- Part 2 Matrix of Compliance Requirements
- Part 3 Compliance Requirements
- Part 4 Agency Program Requirements
- Part 5 Clusters of Programs
- Part 6 Internal Control
- Part 7 Guidance for Auditing Programs Not Included in This *Compliance Supplement*
- Appendix I Federal Programs Excluded from the A-102 Common Rule
- Appendix II Federal Agency Codification of Certain Government-wide Grants Requirements
- Appendix III Federal Agency Contacts for A-133 Audits
- Appendix IV Internal Reference Tables
- Appendix V List of Changes for the Current Year *Compliance Supplement*
- Appendix VI Other OMB Circular A-133 Advisories
- Appendix VII SAS 70, *Examinations of EBT Service Organizations*
- Appendix VIII *Compliance Supplement* Core Team

PART 1: BACKGROUND, PURPOSE, AND APPLICABILITY

A-133 and the Single Audit Act Amendments of 1996 (1996 Amendments) provide for the Office of Management and Budget (OMB) to issue a compliance supplement to assist auditors in performing single audits. The *Compliance Supplement* identifies the compliance requirements that the federal government expects to be considered as part of a single audit. Without this tool, auditors would need to perform additional research to determine the compliance requirements that are important to the federal government and that could have a direct and material effect on a program. For the programs that it includes, the *Compliance Supplement* provides a single source of information for auditors to understand the programs' objectives, procedures, and compliance requirements as well as audit objectives and suggested audit procedures for determining compliance with those requirements. For programs that it does not include, the *Compliance Supplement* provides guidance to help auditors determine applicable compliance requirements, audit objectives, and audit procedures.

In auditing the compliance requirements applicable to programs that are included in the *Compliance Supplement*, auditors should consider not only the compliance requirements in the *Compliance Supplement*, but also the program's laws, regulations, and provisions of contracts or grant agreements and other OMB Circulars (such as the cost principles Circulars) as referenced by the *Compliance Supplement*. Although A-133 requires federal agencies to provide annual updates to the *Compliance Supplement*, laws and regulations change periodically and delays will occur between those changes and the resulting revisions to the *Compliance Supplement*. (A heading on each page of the *Compliance Supplement* indicates the date of the information.) Further, there may be provisions of contracts and grant agreements that are unique to a particular auditee and, therefore, not be included in the *Compliance Supplement*. For example, a grant agreement may specify a particular matching percentage, or an auditee may have agreed to additional compliance requirements that are not required by law or regulation, perhaps as part of resolving prior audit findings.

For federal programs that are not included in the *Compliance Supplement*, the supplement provides guidance in parts 3 and 7 to help auditors identify the compliance requirements that could have a direct and material effect on a program.

Because the *Compliance Supplement's* suggested audit procedures were written to be able to apply to many different programs administered by many different entities, they are necessarily general in nature. Auditor judgment will be necessary to determine whether the suggested audit procedures are sufficient to achieve the stated audit objectives or whether additional or alternative audit procedures are needed. Therefore, OMB states, in part 1, that the auditor should *not* consider the *Compliance Supplement* to be a "safe harbor" for identifying the audit procedures to apply in a particular engagement.

However, OMB states that the auditor can consider the *Compliance Supplement* a "safe harbor" for identification of compliance requirements to be tested for the programs included in it if, as discussed above, the auditor (1) performs reasonable procedures to ensure that the requirements in the *Compliance Supplement* are current and to determine whether there are any additional provisions of contract and grant agreements that should be covered by an audit under the 1996 Amendments and (2) updates or augments the requirements contained in the *Compliance Supplement* as appropriate.

PART 2: MATRIX OF COMPLIANCE REQUIREMENTS

Part 2 is a matrix that associates the federal programs included in the *Compliance Supplement* with the applicable types of compliance requirements. For those included programs and each of the fourteen types of compliance requirements listed in part 3 of the *Compliance Supplement*, which are discussed below, the matrix indicates whether the type of compliance requirement may apply or, instead, whether the program normally does not have activity subject to that type of requirement. Auditors should use judgment in applying the matrix. That is, even though a type of compliance requirement applies to a program, it may not apply to a particular auditee because the auditee does not have the type of activity subject to that requirement or the activity could not materially affect the auditee's program. For example, a program could be subject to the program income compliance requirement, but the auditee does not have program income (or a material amount of program income) in its particular program. Similarly, the auditee may have activity subject to a type of compliance requirement that is not normally applicable to an included program because of special provisions in its contract or grant agreement. Auditors should consider including a copy of the matrix in the audit working papers to support their consideration of compliance requirements for listed programs. Auditors also could develop a similar matrix presentation for their consideration of the types of compliance requirements that apply to programs that are not included in the *Compliance Supplement*.

PART 3: COMPLIANCE REQUIREMENTS

Part 3 lists and describes the fourteen types of compliance requirements and the related audit objectives that the auditor should consider in every single audit. Suggested audit procedures also are provided to help the auditor plan and perform compliance test work. Auditors should use judgment to determine whether the suggested audit procedures will achieve the stated audit objectives and whether additional or different audit procedures are needed. The *Compliance Supplement* clarifies that the auditor is responsible for determining the nature, timing, and extent of the audit procedures needed to meet the audit objectives, whether or not an auditee's major programs are included in the *Compliance Supplement*.

The introduction to part 3 also discusses the administrative requirements that apply to federal grants and cooperative agreements to states, local governments, and not-for-profit organizations—generally the A-102 Common Rule and OMB Circular A-110. That discussion notes those situations in which those two sets of administrative requirements would not apply or when a federal agency may have modified provisions of the rules. (Additional information about those administrative requirements are available in appendixes I and II of the *Compliance Supplement*.)

The fourteen types of compliance requirements are as follow:

- 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, and 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 *Compliance Supplement* presents the individual types of compliance requirements in a generic fashion. Four of the compliance requirements vary by program:

1. Activities allowed or unallowed
2. Eligibility
3. Matching, level of effort, and earmarking
4. Reporting.

For those four, specific requirements for the programs that are included in the *Compliance Supplement* are in part 4. Also, because the compliance requirements for special tests and provisions are unique to each federal program, compliance requirements, audit objectives, and suggested audit procedures for those requirements are not included in part 3; they are included in part 4 for the programs that are included in the *Compliance Supplement*.

Auditees have different structures and systems to control compliance with federal program requirements; therefore, part 3 of the *Compliance Supplement* does not include suggested audit procedures to test internal control. The auditor has to determine appropriate procedures for testing internal control at individual auditees considering factors such as the auditee's internal control, the compliance requirements, the audit objectives for compliance, the auditor's assessment of control risk, and the A-133 requirements to test internal control. As discussed below, however, part 6 of the *Compliance Supplement* helps in this regard.

The following briefly discusses the fourteen types of compliance requirements:

A. Activities Allowed or Unallowed

This type of compliance requirement specifies the activities that can or cannot be financed under a specific program. The specific requirements for this type of compliance requirement are unique to each federal program and are found in the laws, regulations, and provisions of contracts or grant agreements for each program.

B. Allowable Costs/Cost Principles

This type of compliance requirement specifies the types of direct and indirect costs that can be charged to federal programs. Generally, costs must be reasonable and necessary, be allocable under the provisions of OMB's cost principles circulars, be given consistent treatment through the application of GAAP, and conform to legal or regulatory limitations or exclusions. Costs must be net of all applicable credits, such as purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or rebates, and adjustments for overpayments or erroneous charges. Costs also must be documented in accordance with administrative requirements. Indirect costs must be charged in accordance with an appropriate cost allocation plan (CAP) or indirect cost rate agreement (IDCRA). Also, institutions of higher education that receive more than \$25 million in federal funding are required to prepare and submit a Disclosure Statement (DS-2) describing the institution's cost accounting practices.

The *Compliance Supplement* discusses the applicability of the various OMB cost principles circulars and provides a matrix comparing the provisions of those circulars. It also discusses CAPs, indirect cost rate proposals, and IDCRA. Because indirect costs often are charged based on prior-year costs, the *Compliance Supplement* discusses audit timing considerations for testing those costs. Those audit timing considerations are discussed in chapter 6 of this practice guide.

C. Cash Management

This type of compliance requirement specifies how recipients are to manage the timing of the receipt of federal cash. For programs financed on a cost-reimbursement basis, program costs must be paid before reimbursement can be claimed. For programs that are advance funded, recipients and subrecipients must have procedures in place to minimize the time between receipt and disbursement. There are requirements for local governments and not-for-profit organizations to remit interest earned on advances to the federal government. States are required to enter into cash management agreements with the U.S. Treasury. The *Compliance Supplement* provides citations for the various sources of cash management requirements.

D. Davis-Bacon Act

The Davis-Bacon Act or program legislation may require that all laborers and mechanics employed by contractors or subcontractors working on federally financed construction projects in excess of \$2,000 to be paid U.S. Department of Labor–designated prevailing wage rates.

E. Eligibility

This type of compliance requirement specifies the criteria for determining the individuals, groups of individuals, and subrecipients that can participate in a program and the amounts for which they qualify. The specific requirements for this type of compliance requirement are unique to each federal program and are found in the laws, regulations, and provisions of contracts or grant agreements for each program.

F. Equipment and Real Property Management

This type of compliance requirement specifies how a non-federal entity is to use, manage, and dispose of federally financed equipment and real property. The requirements differ depending on the type of non-federal entity and whether the award was direct or indirect. The compliance requirements discussed in the *Compliance Supplement* are primarily concerned with equipment accounting and inventory systems as well as remittance to the federal government of its share of any proceeds from the disposition of equipment or real property.

G. Matching, Level of Effort, and Earmarking

Matching requirements provide that a recipient is to pay a specified amount or percentage of program costs—in cash or in-kind contributions—from non-program sources. Level of effort includes requirements for (1) a specified level of service to be provided from period to period, (2) a specified level of expenditures from non-federal or federal sources for specified activities to be maintained from period to period, and (3) federal funds to supplement and not supplant non-federal funding of services. Earmarking includes requirements that specify the minimum or maximum amount or percentage of the program's funding that must or may be used for specified activities. The specific requirements for this type of compliance requirement are unique to each federal program and are found in the laws, regulations, and provisions of contracts or grant agreements for each program. However, for matching, the A-102 Common Rule and A-110 provide detailed criteria for acceptable costs and contributions.

H. Period of Availability of Federal Funds

This type of compliance requirement specifies the time period during which a non-federal entity may use program funds. There may be requirements relating to pre-award costs, the carryover of unused funds, and time limits on the liquidation of obligations incurred during the award period.

I. Procurement and Suspension and Debarment

This type of compliance requirement specifies the procedures a non-federal entity should use to procure federally financed goods and services. The requirements differ depending on the type of non-federal entity and whether the award was direct or indirect. The *Compliance Supplement* provides citations for the various sources of procurement requirements. This type of compliance requirement also prohibits non-federal entities from contracting with or making subawards to parties that are suspended or debarred from receiving federal funds. The suspension and debarment requirements apply to any procurement contracts of \$100,000 or more and to subawards of any amount.

J. Program Income

This type of compliance requirement specifies the use of income that is directly generated by a program during the grant period. Program income includes fees for services performed and the use or rental of grant-financed property, proceeds from the sale of commodities or other items fabricated under a grant agreement, and the payment of principal and interest on grant-financed loans. Program income does not include interest on grant funds; rebates, credits, discounts, or refunds or interest earned on those amounts; or the proceeds from the sale of equipment or real property. (Those items are addressed under other types of compliance requirements.) Program income may be deducted from program outlays, added to the program budget, or used to meet matching requirements. The *Compliance Supplement* provides sources of program income requirements.

K. Real Property Acquisition and Relocation Assistance

The Uniform Relocation Assistance and Real Property Acquisitions Policies Act of 1970, as amended (URA), requires uniform and equitable treatment of persons displaced from their homes, businesses, or farms by federal programs. URA and implementing regulations provide requirements for property appraisals, the determination of payments for replacement housing, rental and down payment assistance, and the payment of moving and reestablishment expenses.

L. Reporting

This type of compliance requirement specifies the financial, performance, and special reports that non-federal entities must submit about program activities. The *Compliance Supplement* describes the various reports that may be required. The basis of accounting for financial reports is prescribed by the federal or pass-through agency and may not necessarily be the same as the basis of accounting used in the auditee's accounting system or financial statements. Compliance testing of performance and special reports are required only for data that are quantifiable, could have a direct and material effect on a program, and are capable of evaluation against objective criteria. (Part 7 of the *Compliance Supplement* explains the following information for performance reporting and special reporting. If there is a program in the *Compliance Supplement* funded by the same federal agency that requires the same performance or special reporting required by the program for which the auditor is seeking to identify compliance requirements and the *Compliance Supplement* requires testing of those data, then the auditor should use such guidance in identifying compliance requirements to test. Otherwise, the auditor is required only to test financial reporting.) Although there are several standard federal financial reports, the specific requirements for this type of compliance requirement are unique to each federal program and are found in the laws, regulations, and provisions of contracts or grant agreements for each program.

M. Subrecipient Monitoring

This type of compliance requirement specifies the responsibilities that a pass-through entity has related to its subrecipients. For example, a pass-through entity is required to identify to its subrecipients federal award information and applicable compliance requirements, monitor subrecipients' activities to provide reasonable

assurance that subrecipients administer awards in compliance with federal requirements, and ensure that required audits are performed and that subrecipients take prompt corrective action on any audit findings. A pass-through entity also is required to evaluate the effect of subrecipients' activities on its own ability to comply with applicable federal regulations. The *Compliance Supplement* notes that factors such as the size of awards, percentage of the total program's funds awarded to subrecipients, and the complexity of the compliance requirements may influence the extent and nature of a pass-through entity's monitoring procedures. The *Compliance Supplement* provides citations for the various sources of subrecipient monitoring requirements. A-133 also establishes subrecipient monitoring requirements.

N. Special Tests and Provisions

The specific requirements for special tests and provisions are unique to each federal program and are found in the laws, regulations, and provisions of contracts or grant agreements pertaining to the program. The auditor also should ask for the auditee's help in identifying and understanding any special tests and provisions. Further, for all major programs, whether or not included in the *Compliance Supplement*, the auditor should identify any additional compliance requirements that are not based in law or regulation (for example, they were agreed to as part of audit resolution of prior audit findings) that could have a direct and material effect on the program.

PART 4: FEDERAL AGENCY PROGRAM REQUIREMENTS

Part 4 of the *Compliance Supplement* provides program objectives, program procedures, and certain compliance requirements for specific federal programs. Page numbers for part 4 are based, in part, on the CFDA numbers of the programs included.

Part 4 does not include research and development (R&D) and student financial aid (SFA) programs; those are presented in part 5, as discussed below.

The description of program procedures in part 4 is general in nature. Some programs may operate somewhat differently than described for various reasons—for example, (1) complex federal and state laws and regulations, (2) the administrative flexibility provided in program or other regulations, and (3) the nature, size, and volume of transactions involved. Therefore, the auditor should obtain an understanding of the program procedures in operation at the auditee and the applicable compliance requirements to properly plan and perform the audit rather than relying solely on the *Compliance Supplement*.

When four types of compliance requirements—(1) activities allowed or unallowed; (2) eligibility; (3) matching, level of effort, and earmarking; and (4) reporting—apply to one of the programs included in the *Compliance Supplement*, part 4 always provides information specific to the program. The auditor should look to part 3 for a general description of those compliance requirements and to part 4 for information about the specific requirements for a program. Except for special tests and provisions, part 3 also includes the audit objectives and suggested audit procedures pertaining to the type of compliance requirement for the programs in part 4. Because special tests and provisions are unique to each federal program, the compliance requirements, audit objectives, and suggested audit procedures for included programs are in part 4.

The other nine types of compliance requirements generally are not specific to a program and, therefore, usually are not included in part 4. However, when one of those other nine types of compliance requirements have information specific to a program, that specific information is provided with the program in part 4. For example, the discussion in part 4 of the *Compliance Supplement* for the food stamp cluster, CFDA programs 10.551 and 10.561, includes compliance requirements for procurement and suspension and debarment.

Therefore, in developing compliance testing procedures for one of the included programs, auditors should first refer to the matrix of compliance requirements in part 2 of the *Compliance Supplement* to identify which of the fourteen types of compliance requirements described in part 3 are applicable. Then, the auditor should look to parts 3 and 4 for the details of the requirements.

PART 5: CLUSTERS OF PROGRAMS

Part 5 identifies those programs that OMB has designated as clusters. OMB has designated R&D, which does not have CFDA numbers, and SFA in addition to other clusters of programs as listed in the practice Aid portion of this practice guide. A-133 also permits states to designate program clusters for their subrecipients. Such designations should be apparent in state award documents.

A-133 requires clusters of programs to be treated as a single program for purposes of determining and testing major programs and, with the exception of R&D, for determining whether a program-specific audit may be elected. Therefore, in planning and performing the audit, the auditor should determine whether programs administered by the auditee are part of a cluster by referring to part 5 of the *Compliance Supplement* and the state award documents.

R&D and SFA are listed on the matrix of compliance requirements in part 2 of the *Compliance Supplement*. For R&D and SFA, part 5 provides program objectives and procedures and compliance requirements the same as part 4 does for other federal programs. For SFA, it also provides audit objectives and suggested audit procedures for special tests and provisions.

PART 6: INTERNAL CONTROL

In receiving federal awards, entities agree to comply with applicable laws and regulations and the provisions of contracts or grant agreements and to maintain internal control to provide reasonable assurance of compliance with those requirements. A-133 requires auditors to obtain an understanding of an auditee's internal control over federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs, 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, unless internal control is likely to be ineffective, perform testing of internal control as planned. Part 6 of the *Compliance Supplement* is designed to help auditees and their auditors comply with those requirements by presenting characteristics of internal control that may be used to reasonably ensure compliance with the types of compliance requirements in part 3.

Part 6 presents the objectives and characteristics of internal control for each of the compliance requirements presented in part 3—except special tests and provisions. The presentation uses the components of internal control discussed in Internal Control-Integrated Framework (COSO Report), published by the Committee of Sponsoring Organizations of the Treadway Commission.¹ The characteristics of internal control presented in part 6 of the *Compliance Supplement* are neither mandatory nor all-inclusive. Instead, the presentation is intended to provide auditees and auditors with guidance about the design and implementation of appropriate and cost-effective internal control over federal programs.

¹ The COSO Report provides a framework for organizations to design, implement, and evaluate controls to facilitate compliance with the requirements of federal laws, regulations, and program compliance requirements. Statement on Auditing Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), and a related AICPA Audit Guide, *Consideration of Internal Control in a Financial Statement Audit*, incorporate the internal control components presented in the COSO Report. Chapter 5 of this practice guide includes further discussion of the components of internal control.

PART 7: GUIDANCE FOR AUDITING PROGRAMS NOT INCLUDED IN THE COMPLIANCE SUPPLEMENT

Part 7 explains to auditors how to identify the compliance requirements and design compliance tests for programs not included in the *Compliance Supplement*. Because the *Compliance Supplement* includes only a portion of the more than 600 current federal programs, it is likely that auditors will have to test as major programs many that are not included in the supplement.

For major programs that are not included in the *Compliance Supplement*, the auditor has to identify the compliance requirements that could have a direct and material effect on a program. Part 7 indicates that while a federal program may have many compliance requirements, normally there are only a few key compliance requirements that could have a direct and material effect. Because the single audit process is not intended to cover every compliance requirement, the auditor's focus should be on the fourteen types of compliance requirements included in part 3.

Part 7 also indicates that, although the focus of the *Compliance Supplement* is on compliance requirements that could have a direct and material effect on a major program, auditors have a responsibility under GAS for other requirements when specific information comes to their attention about the existence of possible noncompliance that could have a material indirect effect on a major program. (See *Government Auditing Standards*, chapter 4.)

Part 7 presents the following five questions the auditor should address to determine the compliance requirements to test.

1. *What are the program objectives, program procedures, and compliance requirements for the program?*

The *Compliance Supplement* indicates that the auditor's first steps are to understand how the program works and the laws, regulations, and provisions of contracts or grant agreements that pertain to it. It suggests that the auditor—

- Discuss the program with the auditee and, if needed, the federal agency or pass-through entity.
- Review the contracts and grant agreements and referenced laws and regulations applicable to the program.
- Review the CFDA listing for the program.
- Consider the guidance in a program-specific audit guide or other audit guidance issued by the federal agency.
- Consider whether guidance in any previous OMB-issued compliance supplement is helpful and has continuing relevance.

2. *Which of the compliance requirements could have a direct and material effect on the program?*

The *Compliance Supplement* indicates that assessing materiality is based on both qualitative and quantitative aspects and suggests that the following characteristics could indicate that a compliance requirement has a direct and material effect on a program—

- Noncompliance could likely result in questioned costs.
- The requirement affects a large part of the program, such as a material amount of program dollars.
- Noncompliance could cause the federal agency or pass-through entity to take action, such as seeking reimbursement of program costs or suspending the auditee's participation in the program.

3. *Which of the compliance requirements are susceptible to testing by the auditor?*

The auditor is expected to test compliance only for those requirements that he or she can evaluate against objective criteria and for which he or she reasonably can be expected to recognize noncompliance. The auditor is expected to test compliance requirements that are practical to test, for which an audit objective can be written that supports an opinion on compliance, and for which testing adds value. Testing would add value if the auditor could document noncompliance in a manner that permits the federal agency or pass-through entity to take action or that gives the federal agency or pass-through entity information it does not otherwise have. The auditor is not expected to test compliance with requirements that the federal agency or pass-through entity should have the ability to verify in the normal course of administering the program—such as compliance with report submission deadlines.

4. *Into which of the fourteen types of compliance requirements does each compliance requirement fall?*

The auditor should relate each of the compliance requirements he or she identifies for testing to one of the fourteen types of compliance requirements included in part 3 of the *Compliance Supplement*. Not only will this assist the auditor in using the compliance requirements, audit objectives, and suggested audit procedures in part 3; it also will assist later in the reporting process, when auditors are required to relate any federal program findings to a type of compliance requirement. This section of part 7 discusses the likelihood of whether each of the fourteen types of compliance requirements would apply to individual federal programs. For example, it indicates that the equipment and real property management compliance requirement applies to programs that purchase equipment or real property.

5. *For special tests and provisions, what are the applicable audit objectives and audit procedures?*

This section of part 7 reminds the auditor that part 3 of the *Compliance Supplement* does not include generic audit objectives and suggested audit procedures for special tests and provisions, although it does include guidance for identifying those objectives and procedures. Special tests and provisions will include any identified compliance requirements that do not fit the description of one of the other thirteen types of compliance requirements.

COMPLIANCE SUPPLEMENT APPENDIXES

The *Compliance Supplement* includes eight appendixes. Appendix I, “Federal Programs Excluded from the A-102 Common Rule, lists the programs to which those administrative requirements do not apply. Those programs include block grant programs enacted under the Omnibus Budget Reconciliation Act of 1981, the Department of Education’s Title I program, open-ended entitlement programs (which are certain HHS and USDA programs), and other specified programs. Instead of the A-102 Common Rule requirements, state administrative requirements for financial management and control apply to the block grant programs and federal agency regulations apply to the programs that are not block grants. The administrative requirements for open-ended entitlement programs that differ significantly from the A-102 Common Rule concern real property and equipment, procurement, and financial reporting. This appendix also indicates that the block grant programs and Title I are exempt from the OMB cost principles circulars; state cost principles requirements apply.

Appendix II, Federal Agency Codification of Certain Government-wide Grants Requirements, is a matrix that presents the regulatory citations for the codifications by various federal departments and agencies of the provisions of the A-102 Common Rule and A-110. Some agencies have not yet codified the November 1993 revision to A-110 (although it applies to them and to their awards) and either are in the process of doing so or have provided such policies to grantees through other means such as grant agreements.

Appendix III, Federal Agency Contacts for A-133 Audits, identifies federal agency contacts, including address, telephone and facsimile numbers, and sometimes, Internet sites and electronic mail addresses. Auditors can use these contacts to request information or materials about federal programs or the audit requirements of A-133.

Appendix IV, Internal Reference Tables, provides a listing of programs in parts 4 and 5, which include "IV. Other Information." That listing allows the auditor to quickly determine which programs have other information, such as guidance on Type A and Type B program determination or display on the schedule of expenditures of federal awards. Also identified in this appendix are the programs identified as higher risk by OMB pursuant to Circular A-133, §____.525(c)(2).

Appendix V, List of Changes for the Current Year *Compliance Supplement*, provides a list of changes from the OMB Circular A-133 *Compliance Supplement* issued in the year prior to the current year

Appendix VI, Other OMB Circular A-133 Advisories, provides a copy of other OMB advisories. Both advisories concern the Year 2000 Issue.

Appendix VII, SAS 70, *Examinations of EBT Service Organizations*, provides guidance on audits of state electronic benefits transfer (EBT) service providers (service organizations) regarding the issuance, redemption, and settlement of benefits under the food stamps program (CFDA 10.551) in accordance with the American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324).

Appendix VIII, *Compliance Supplement* Core Team, provides a listing of the *Compliance Supplement* core team members who were responsible for the production of the *Compliance Supplement*.

CHAPTER 3: Procurement of Auditor Services

This chapter highlights the auditee’s responsibility for selecting an auditor, preparing a request for proposal (RFP), and administering the RFP process. This information will help auditors understand the procurement process used to obtain audit services and provide a basis for the auditor to evaluate whether the auditee has complied with it. The chapter also discusses auditors’ proposals for audit services and considerations that auditors should address in deciding whether to accept an engagement to perform an Office of Management and Budget (OMB) Circular A-133 (A-133) audit. Finally, it discusses the auditor’s involvement with assertions made by auditee management about internal control in applying for grants.

AUDITEE’S RESPONSIBILITY FOR SELECTING THE AUDITOR

A-133 requires auditees to comply with specific procurement standards when arranging for audit services. Those standards, which provide minimum requirements for procedures to be followed in procuring goods and services, are summarized in the following table. Individual federal program regulations and contract and grant agreements may provide additional procurement standards.

<u>APPLICABLE TO:</u>	<u>STANDARDS</u>
States and local governments	OMB Circular A-102, <i>Grants Management Common Rule, Uniform Administrative Requirements for Grants and Cooperative Agreements with State and Local Governments</i> (A-102 Common Rule) ¹
Institutions of higher education, hospitals, and other not-for-profit organizations	OMB Circular A-110, <i>Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations</i>
Other entities subject to A-133	Federal Acquisition Regulation (48 CFR part 42)

The appendix to the Practice Aids portion of this practice guide provides sources for obtaining those federal standards. A questionnaire that may assist an auditor in evaluating whether the auditee has complied with the procurement requirements is provided in the Practice Aids portion of this practice guide.

A-133 also states that the auditee should—

1. Whenever possible, make positive efforts to use small businesses, minority-owned firms, and women’s business enterprises to obtain audit services. (If part of the audit is to be performed by another auditor, Statement on Auditing Standards [SAS] No. 1, *Codification of Auditing Standards and Procedures*

¹ Certain grant programs, including block grants enacted under the Omnibus Reconciliation Act of 1981 and open-ended entitlement programs, are excluded from the requirements of the A-102 Common Rule. See the section entitled “Compliance Supplement Appendixes” in chapter 2 of this practice guide and the listing in Appendix I of the Compliance Supplement.

[AICPA, *Professional Standards*, vol. 1, AU section 543, “Part of Audit Performed by Other Independent Auditors”], provides guidance.²)

2. When requesting proposals for audit services, clearly state the objective and scope of the audit.
3. When evaluating proposals, consider the—
 - a. Respondents’ responsiveness to the request for proposal.
 - b. Respondents’ relevant experience.
 - c. Availability of qualified staff.
 - d. Results of the external quality review.
 - e. Price.

AUDITOR INVOLVEMENT WITH INDIRECT COST RATE PROPOSALS AND COST ALLOCATION PLANS

A-133 precludes an audit firm that prepares the indirect cost rate proposal (IDCRP) or cost allocation plan (CAP) from being selected to conduct the audit when the indirect costs recovered by the auditee during the prior year exceeded \$1 million. The restriction applies not only to the base year used in preparing the IDCRP or CAP, but also to any subsequent year in which the resulting indirect cost rate agreement or CAP is used to recover costs. This restriction resulted from federal agency concerns of at least an appearance of a lack of independence when the same firm both performs the audit and prepares the IDCRP or CAP. The \$1 million threshold was chosen to limit the restriction to relatively few entities.

REQUESTS FOR PROPOSALS

The auditee may issue an RFP when engaging an auditor to conduct an A-133 audit. In March 2000, the Mid-American Governmental Audit Forum issued a publication, *Choosing an External Auditor—Guide for Making a Sound Decision*, which is a publication useful during the audit procurement process. Also, the Government Finance Officers Association publishes an *Audit Management Handbook*. (the appendix to the Practice Aids portion of this practice guide provides sources for obtaining these documents). The *Audit Management Handbook* provides information on all aspects of the audit management process, including establishing the scope of the audit, audit procurement (including a model request for proposal available in diskette form), monitoring the audit, and the resolution of audit findings.

The use of these documents is not required but may be useful. Exhibit 3-1 illustrates the process for awarding an audit contract.

DETERMINING WHETHER TO ACCEPT A CLIENT

Good business and professional practices provide that a professional services firm should have policies, procedures, and guidelines concerning accepting and retaining clients. The *AICPA Audit and Accounting Manual (AAM)*, section 11,300, includes illustrative quality control forms and aids that contain suggested considerations for accepting and retaining clients.

² Further discussion of joint audits and reliance on other auditors is in chapter 4 of this practice guide and chapter 3 of Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.

The Practice Aid checklist, New Client Evaluation for A-133 Audits, has been developed using illustrative material contained in section 11,300 of AAM and provides information that the auditor needs to assess whether to accept a prospective client. The information required to complete the checklist and to make the required evaluation often can be obtained from the RFP and from discussions with the prospective client's personnel. Some of the information also may be obtained from the current or former independent auditor, from a review of the prospective client's financial statements and other reports, and from other sources, such as industry and accounting journals and Internet sites.

Section 11,300.23 of AAM includes a Client/Engagement Acceptance and Continuation Checklist that auditors may wish to use to help determine whether to continue to serve an existing client.

RESPONDING TO AN RFP: SUBMITTING A PROPOSAL

The audit proposal is an offer that, if accepted by the auditee, becomes a legally binding contract. Therefore, auditors should prepare and submit proposals with care, using all available information.

The proposal must be responsive to the RFP, complete, and submitted by the date and time specified. Proposals submitted after the deadline often are not considered. The proposal, or a cover letter that transmits it, should indicate the date until which the proposal for audit is valid and binding on the auditor.

Preparing and submitting audit proposals are time-consuming and costly. RFPs may be for audit services for one year or for a multiyear period. Some entities have formal or informal mandatory auditor rotation policies. Auditors should obtain and evaluate information about the length of the audit contract and auditor rotation policies before deciding whether to submit a proposal.

FIRST-YEAR PROPOSALS FOR A SINGLE AUDIT

When submitting a proposal to conduct a single audit for the first time, auditors may not have sufficient information to determine which programs would be audited using the risk-based approach to determine major programs. To help alleviate this possible problem, the OMB permits a deviation from the use of the risk-based approach for first-year audits. (A first-year audit is the first year the entity is audited under A-133 or the first year of a change of auditors. However, the election may not be used for an auditee more than once every three years.) Specifically, for first-year audits, the auditor may elect to determine major programs as all Type A programs plus any Type B programs needed to meet the percentage-of-coverage rule. Depending on the circumstances, auditors may wish to consider this first-year option when responding to an RFP to conduct a single audit.

QUALITY CONTROL REVIEW REPORTS

GAS and thereby A-133 require auditors to submit a copy of their latest quality control review report to those contracting for such audits. (The term *report* does not include separate letters of comment.)

ENGAGEMENT LETTERS AND OTHER COMMUNICATIONS

SAS No 83, *Establishing an Understanding With the Client*, as amended by SAS No. 89, *Audit Adjustments* (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 an understanding reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other party. In addition, *Government Auditing Standards*, chapter 4, requires that auditors communicate information to the auditee, the individuals contracting for or requesting the audit, and the audit committee regarding the nature and extent

of planned testing and reporting on compliance with laws and regulations and internal control over financial reporting. This communication must take place during the planning stages of the audit. Although that communication is not required to be in writing, many auditors provide it in the engagement letter. Also, although not required, the auditor may find it beneficial to discuss the scope of the engagement with the cognizant or oversight agency for audit, federal awarding agencies, and pass-through entities to ensure that the audit will meet their requirements.

A Single Audit Engagement Letter Checklist and an Illustrative Single Audit Engagement Letter are included in the Practice Aids portion of this practice guide.

INDEPENDENCE

In deciding whether to accept an engagement to conduct an A-133 audit (or to continue an existing audit relationship), auditors should consider the second general standard as discussed in SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 220, "Independence"), and in chapter 3, *Government Auditing Standards* (GAS). GAS states that "in all matters relating to the audit work, the audit organization and the individual auditors, whether government or public, should be free from personal and external impairments to independence, should be organizationally independent, and should maintain an independent attitude and appearance."

Auditors also should specifically consider Ethics Interpretation 101-10, "The Effect on Independence of Relationships With Entities Included in Governmental Financial Statements" of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12). That interpretation discusses the effect on independence of relationships between an auditor and a primary government and its component units.

PRE-AWARD SURVEYS

In applying for a government grant or contract, an entity may be required to submit a written assertion (a pre-award survey) about the effectiveness or suitability of the design of part or all of its internal control together with a practitioner's report thereon. The Interpretation in AT section 9400 of AT section 400, *Reporting on an Entity's Internal Control Over Financial Reporting*,³ provides the following guidance.

A practitioner may not issue such a report based on the consideration of internal control in an audit of the entity's financial statements. The purpose of considering internal control in a financial statement audit is to obtain an understanding sufficient to plan the audit and to determine the nature, timing, and extent of audit tests to be performed—not to provide assurance on internal control. The financial statement audit does not provide the practitioner with a sufficient basis to issue a report expressing any assurance about the effectiveness of the design of part or all of the entity's internal control.

To issue such a report, a practitioner should perform an examination of or apply agreed-upon procedures to management's written assertion as described in AT section 400, paragraphs .22 through .25 and .71 through .77.⁴ When the engagement involves the application of agreed-upon procedures to a written assertion about

³ In January 2001, the Auditing Standards Board issued Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification*, SSAE No. 10 superseded SSAE Nos. 1 through 9 and is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001; early application is permitted. See SSAE No. 10; AT sec. 9501.01, which includes guidance related to the Interpretation, "Reporting on an Entity's Internal Control Over Financial Reporting."

⁴ See the previous footnote regarding issuance of SSAE No. 10. SSAE No. 10, AT sec. 501, sets forth related guidance.

the design effectiveness of the entity's internal control over compliance with specified requirements, the practitioner also should follow the provisions of AT sections 500, *Compliance Attestation*, paragraphs .09 and .14 through .28, and 600, *Agreed-Upon Procedures Engagements*.⁵

If a practitioner is asked to sign a form prescribed by a governmental agency in connection with a pre-award survey, he or she should refuse to sign the form unless he or she has performed an attestation engagement. The practitioner also should consider whether the wording of the prescribed form conforms to the requirements of professional standards. If it does not, the practitioner should either reword the form to conform to those standards or attach a separate report conforming with such standards in place of the prescribed form.

An entity also may be required to submit a pre-award survey about its ability to establish suitably designed internal control accompanied by a practitioner's report. A practitioner should not issue such a report because neither the consideration of internal control in an audit of an entity's financial statements nor the performance of an attestation engagement provides the practitioner with a basis for issuing such a report. An assertion about ability is not capable of reasonably consistent estimation or measurement. However, the requesting agency may be willing to accept a report of the practitioner on a nonattest service as described in AT section 100, *Attestation Standards*, paragraphs .02 and .87.⁶ The practitioner should consider including the following in the nonattest service report

1. A statement that the practitioner is unable to perform an attest engagement on the entity's ability to establish suitably designed internal control because there are no criteria that are capable of reasonably consistent estimation or measurement for assessing such an assertion
2. A description of the nature and scope of the practitioner's services
3. The practitioner's findings

⁵ See footnote 3 regarding issuance of SSAE No. 10. SSAE No. 10, AT sec. 601, sets forth guidance for compliance attestation, and SSAE No. 10, AT sec. 201, sets forth guidance concerning performance and reporting in all agreed-upon-procedures engagements.

⁶ See footnote 3 regarding issuance of SSAE No. 10. SSAE No. 10, AT sec. 101, sets forth guidance regarding attest engagements.

EXHIBIT 3-1 • ILLUSTRATIVE PROCESS FOR AWARDING AN AUDIT CONTRACT

<i>Who?</i>	<i>What?</i>	<i>Why?</i>
Auditee	Issues RFP	<ul style="list-style-type: none"> • To invite proposals to perform the audit • To provide information about the entity and the required audit
Auditee and auditor	Holds and attends bidders conference, respectively	<ul style="list-style-type: none"> • To provide additional information • To provide an opportunity to ask questions
Auditor	Makes other contacts with the auditee, if permissible	<ul style="list-style-type: none"> • To obtain additional information (Frequently governments do not permit such contacts.)
Auditor	Submits proposal	<ul style="list-style-type: none"> • To offer to conduct the audit (The proposal must be submitted timely and include all information requested.)
Auditor	Makes oral presentation, if auditee requires or permits	<ul style="list-style-type: none"> • To provide additional information
Auditee	Evaluates proposals	<ul style="list-style-type: none"> • To determine which firm to select to perform the audit
Auditee	Awards the contract	<ul style="list-style-type: none"> • To engage the auditor to perform the audit (Often, the contract comprises the RFP and the proposal; in some cases, however, the auditee and auditor negotiate the contract.)

CHAPTER 4: Planning the Single Audit and Selecting Major Programs

When planning a single audit, the auditor should consider matters in addition to those required for an audit of the financial statements in accordance with generally accepted auditing standards (GAAS) and *Government Auditing Standards* (GAS). This chapter discusses planning considerations for single audits, including the selection of major programs. See chapter 8 for a discussion of program-specific audits performed under the provisions of Office of Management and Budget (OMB) Circular A-133 (A-133).

PLANNING GUIDELINES

Audit planning involves developing an overall strategy for the expected scope and conduct of the audit that continues throughout the audit. Both GAAS and GAS require proper planning of the audit. Planning guidelines are contained in GAAS, GAS, and other documents, including the following:

GAAS includes the following:

- Statement on Auditing Standards (SAS) No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310)
- SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)
- SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)
- SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315)
- SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316)
- SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317)
- SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319)¹
- SAS No. 65, *The Auditor's Consideration of the Internal Audit Functions in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322)
- SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329)
- SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Requirements of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801) GAS (chapter 4) includes the following:
 - Planning
 - Auditor Communication

¹The AICPA Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*. SAS No. 94 amends SAS No. 55, as amended, to provide guidance to auditors about the effect of information technology on internal control and on the auditor's understanding of internal control and assessment of control risk. SAS No. 94 is effective for audits of financial statements for periods beginning on or after June 1, 2001, with earlier application permitted.

- Audit Follow-up
- Fraud, Illegal Acts, and Other Noncompliance
- Internal Control

Other documents include the following:

- AICPA Audit and Accounting Guides:
 - *Audits of State and Local Governmental Units*
 - *Not-for-Profit Organizations*
 - *Health Care Organizations*
 - *Audits of Colleges and Universities*²
 - *Audits of Voluntary Health and Welfare Organizations*
 - *Consideration of the Internal Control in a Financial Statement Audit*
- AICPA Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*
- Audit Practice Release, *Audit Sampling*
- *AICPA Audit and Accounting Manual*

SINGLE AUDIT PLANNING CONSIDERATIONS

In planning a single audit, the auditor should—

- Gain an understanding of the industry, the auditee, and the engagement audit requirements.
- Communicate with the auditee about its reporting responsibilities.
- Establish communication with the federal agencies and pass-through entities, as appropriate.
- Obtain an understanding of the auditee's internal control related to financial statements, the compliance requirements that could have a direct and material effect on major federal programs, and the internal control related to those compliance requirements.
- Perform a preliminary assessment of audit risk at the financial statement level and the major program level.
- Consider the level of materiality at the financial statement level and the major program level.
- Consider other matters as appropriate, including—
 - Initial-year audit considerations.
 - Report submission deadlines.
 - Joint audits and reliance on other auditors.
 - Auditee locations to visit.
- Establish the audit approach, assign audit personnel, and develop audit programs.

² Although two AICPA Industry Audit Guides—*Audits of Colleges and Universities* and *Audits of Voluntary Health and Welfare Organizations*—were superseded for not-for-profit organizations by the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, they remain effective for certain governmental entities until Governmental Accounting Standards Board (GASB) Statements Nos. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities—an amendment of Statement 34*, become effective. See GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.

This chapter provides guidance for each of these planning considerations. Chapter 3 of SOP 98-3 also addresses A-133 audit planning.

GAAS and GAS require the auditor to document the planning phase of the audit in the working papers, including the information gathered, the work performed, and the conclusions reached. For several of the tasks handled during the planning of the single audit—such as the risk assessments for the selection of major programs—A-133 specifically requires documentation in the working papers.

An illustrative A-133 Single Audit Planning Checklist is presented as a Practice Aid to this practice guide.

Understanding the Industry, the Auditee, and the Engagement Audit Requirements

In planning an audit in accordance with GAS and A-133, the auditor should consider the planning requirements of GAAS and certain additional requirements of GAS and A-133 concerning the—

- Scope of the audit.
- Reporting requirements.
- Internal control testing requirements.
- Compliance requirements.
- Working paper documentation and retention requirements.
- Auditee responsibilities.
- Federal agencies responsibilities.

GAAS, GAS, and the applicable AICPA industry accounting and auditing guides provide guidance on planning an audit of an entity's financial statements and understanding the industry in which it operates.

For a single audit, the auditor's understanding of the industry, the auditee, and the engagement requirements for the audit at the financial statement level should be supplemented by performing additional planning procedures, including the following:

- Obtaining the schedule of expenditures of federal awards
- Identifying major programs
- Identifying the requirements of the laws, regulations, and provisions of contracts or grant agreements applicable to the major programs
- Identifying departments, agencies, and locations where major programs are administered and related records are maintained
- Identifying the compliance requirements that could have a direct and material effect on the major programs and the auditee's internal control over those requirements
- Identifying prior audit reports and findings relating to federal programs and evaluating the status of corrective action on those findings

Further, when the engagement includes the selection of major programs using a risk-based approach, the auditor needs to obtain the following additional information about the auditee's federal programs during the planning phase of the audit:

- Correspondence from federal agencies or pass-through entities indicating potential problems
- The results of recent monitoring visits by federal agencies or pass-through entities
- New federal programs administered by the auditee
- Existing federal programs newly administered by the auditee
- Changes to federal program laws, regulations, or compliance requirements since the prior audit

- The amount of funding passed through to subrecipients of individual federal programs and the processes for monitoring those subrecipients
- The extent to which computer processing is used to administer federal programs
- The changes to systems or personnel administering federal programs since the prior audit
- Whether certain federal programs were audited as major programs in the past two years
- Federal programs identified by federal agencies in the *Compliance Supplement* as higher risk (For example, the U.S. Department of Health and Human Services has identified the Medicaid cluster in the *Compliance Supplement* as a program of higher risk.)
- Federal programs, if any, that the awarding agency has notified the auditee that it wants audited as major

The selection of major programs using a risk-based approach, the identification of compliance requirements, and the evaluation of compliance requirements that could have a direct and material effect on an auditee's major program are discussed later in this chapter and illustrated in a case study presented as a Practice Aid to this practice guide.

When planning an audit in accordance with A-133, the auditor determines, among other things—

- Whether an A-133 audit is required.
- Whether the audit will be a single audit or a program-specific audit.
- If a single audit is to be performed, what the reporting entity will be.
- What the audit period will be.
- Whether the auditee is a pass-through entity, a subrecipient, or a vendor.
- How the auditee monitors its subrecipients.
- Whether the auditee meets the criteria for a low-risk auditee.

Is an A-133 Audit Required?

State and local governments and not-for-profit organizations that expend \$300,000 or more in federal awards annually are required to have a single audit or program-specific audit in accordance with A-133. Those that expend less than \$300,000 annually are exempt from federal audit requirements for that year. Auditees that receive biennial audits are subject to an A-133 audit if they expend \$300,000 or more in either of the two years in the biennium.

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, A-133 does not apply to an African nation that expends federal awards to inoculate schoolchildren. However, A-133 does apply to expenditures made by U.S.-based entities outside the United States and to foreign branches of U.S.-based entities. For example, if a university based in the United States expends a federal grant for travel and the three-month rental of a residence in Russia for research about Russian art, the federal award is subject to an A-133 audit. Another example would be a U.S.-based university that receives a federal award to study the progress of infectious diseases in Africa. If the research is conducted by the university's branch research laboratory based in Africa, the federal award is subject to an A-133 audit.

A-133 also does not apply to for-profit entities expending federal awards received either directly as a recipient or indirectly as a subrecipient. An example would be a drug company that expends federal awards in its research on communicable diseases.

Is a Single Audit or Program-Specific Audit Required?

In certain situations—generally when an entity expends federal awards under only one program and an audit of the entity’s financial statements is not federally mandated—the auditee may elect to have a program-specific audit rather than a single audit. See chapter 8 of this practice guide and chapter 11 of SOP 98-3 for further discussions of program-specific audits.

What Will the Reporting Entity Be?

During the planning process of a single audit, the auditor should determine whether management has properly defined the reporting entity. A-133 does not specify what constitutes the auditee’s reporting entity; the reporting entity is defined by GAAP.³ However, A-133 permits the auditee to limit its single audit coverage to those auditee departments, agencies, and other organizational units that expend or otherwise administer federal awards. A department that does not directly receive a federal award but whose costs are charged to a federal award through an indirect cost rate or cost-allocation plan would be required to be included in the single audit because the department expended federal funds. Auditees are permitted to conduct a series of individual audits of departments, agencies, and other organizational units to meet the requirements of A-133.

If an auditee elects the “series of audits” option, separate financial statements and schedules of expenditures of federal awards are to be prepared for each such department, agency, or other organizational unit. In those circumstances, an entity’s organization-wide financial statements may also include the departments, agencies, or other organizational units that have separate audits and prepare separate financial statements.

For example, consider a local government that has a dependent school district that receives federal awards and that is included in the local government’s financial statements as a component unit. A separate single audit of the school district may be conducted, provided separate financial statements and a separate schedule of expenditures of federal awards are prepared for the district. The local government’s financial statements and schedule of expenditures of federal awards that include the district are not an acceptable substitute for the separate statements and schedule. If there are no separate financial statements and no separate schedule, the school district must be audited as part of the local government’s single audit. Specifically, there must be a one-to-one match between financial statements and single audits of departments, agencies, and other organizational units.

A single audit is not required unless a non-federal entity expends \$300,000 or more in federal awards. Continuing the example from above, suppose that the local government expends \$400,000 in federal awards and the school district expends \$200,000. If the school district prepares separate financial statements and those financial statements are audited, the district would not be required to receive a single audit. At the same time, the local government should receive a single audit on its \$400,000 of federal expenditures, even though its GAAP financial statements include the school district as a component unit. (The local government’s schedule of expenditures of federal awards should not include the school district’s federal expenditures; the notes to the schedule should explain the scope of the schedule in relation to the scope of the reporting entity’s financial statements.) However, if the only reporting of the district’s financial statements is as a component unit in the local government’s financial statements or its separate financial statements are not audited, it should be included as part of the local government’s single audit, which would cover the entire \$600,000 of federal expenditures. (In this situation, the schedule of expenditures of federal awards would include the district’s expenditures.)

Entities that own or operate a federally funded research and development center (FFRDC) may elect to treat the FFRDC as a separate entity for purposes of the A-133 audit.

³ See GASB Statement No. 14, *The Financial Reporting Entity*, and Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*.

What Will the Audit Period Be?

The A-133 audit should cover the financial statements and schedule of expenditures of federal awards for the auditee's fiscal year. The auditee's fiscal year may not necessarily be the same as the award period of the federal programs. Nevertheless, the audit should cover expenditures of federal awards made during the entity's fiscal year, not a different federal funding period.

Biennial audits must cover both years within the two-year period and are permitted for—

1. 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. This legal requirement must still be in effect for the biennial period under audit.
2. Any not-for-profit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995

Is the Auditee a Pass-Through Entity, Subrecipient, or Vendor?

During the planning stage of the audit, the auditor determines whether the entity has properly identified itself for purposes of its involvement with various federal programs as a pass-through entity, subrecipient, or vendor. The definitions and responsibilities of each are discussed in the following paragraphs and in chapter 9 of SOP 98-3.

A *pass-through entity* is a non-federal entity that provides a federal award to a subrecipient to carry out a federal program. A pass-through entity has various responsibilities relating to its subrecipients, including providing information about federal awards and compliance requirements, monitoring subrecipients activities, and issuing management decisions on audit findings. See the discussion of subrecipient monitoring considerations in the following section of this chapter.

A *subrecipient* is 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 who is a beneficiary of such a program (such as a student receiving financial aid). A vendor is a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a federal program (such as a grocer selling food to a school for a lunch program). Those goods or services may be for an organization's own use or for the use of the beneficiaries of the federal program.

The difference between subrecipients and vendors is significant for purposes of A-133 audits and administering federal awards. Federal funds expended as a recipient or a subrecipient are subject to an A-133 audit if the entity expended \$300,000 or more of federal awards and is the type of entity subject to A-133 (that is, a state, local government, or not-for-profit entity). Payments from a federal program received by a vendor are not considered federal awards and are not subject to an A-133 audit. If a vendor is inappropriately identified as a subrecipient, the costs of any audit conducted in accordance with A-133 would be unallowable costs affecting both the vendor and the pass-through entity. If a subrecipient is inappropriately identified as a vendor, it would not receive an A-133 audit, potentially placing it and the pass-through entity in violation of the A-133 audit requirements. In addition, pass-through entities have information and monitoring responsibilities toward subrecipients that they generally do not have toward vendors. Therefore, auditors of both pass-through entities and subrecipients should evaluate whether there has been an appropriate evaluation and identification of subrecipients and vendors.

Characteristics that distinguish a subrecipient from a vendor are defined in A-133 as follows:

A subrecipient is a receiving organization that—

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. Is responsible for programmatic decision making.
4. Is responsible for adhering to applicable federal program compliance requirements.
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.

A *vendor* is a receiving organization that—

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.
5. Is not subject to compliance requirements of the federal program.

Not all of the characteristics are present in all situations, so there is a need for in determining whether an entity is a subrecipient or vendor. A-133 indicates that there may be unusual circumstances or exceptions to the listed characteristics.

A checklist for determining the status of an organization as a subrecipient or a vendor is presented in the Practice Aid portion of this practice guide.

In most cases, an auditee's compliance responsibility for vendors is only to ensure that the procurement, receipt, and payment for goods and services comply with the applicable laws, regulations, and provisions of contracts or grant agreements. If the vendor is responsible for program compliance, the auditee is responsible for ensuring compliance. For example, if a service bureau that administers a loan program is responsible for certain compliance requirements, the auditee must ensure that the service bureau complies with those requirements. Also, when vendor transactions are structured so that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine program compliance, the scope of the audit should include those transactions if they are significant to a type of compliance requirement that could have a direct and material effect on a major program.

Examples of pass-through entity–subrecipient relationships include the following:

- A state (pass-through entity) receives federal assistance for a school lunch program that it disburses to school districts (subrecipients) throughout the state.
- A state (pass-through entity) receives federal funds for feeding elderly and low-income individuals that it disburses to not-for-profit organizations (subrecipients) to support programs to feed eligible individuals.

Examples of recipient–vendor relationships include the following:

- A state (recipient) receives federal assistance for a highway improvement project and contracts with a trucking company (vendor) to haul away dirt.
- A not-for-profit organization (recipient) uses federal funds to purchase bread from a bakery (vendor) for its feeding program for elderly and low-income individuals.

What Are the Auditee’s Subrecipient Monitoring Processes?

As discussed above, a pass-through entity is responsible for monitoring compliance by its subrecipients with federal program requirements. The pass-through entity’s subrecipient monitoring processes vary depending on the amounts and nature of the federal awards provided. Accordingly, in planning the audit, the auditor should gain an understanding of—

1. The compliance requirements established by the auditee in its contracts with subrecipients.
2. The scope of the monitoring activities over subrecipients to provide reasonable assurance that they administer federal awards in compliance with federal requirements. Monitoring to ensure compliance may include pre-award audits, monitoring during the contract, and post-award audits
3. The number, size, and complexity of the awards to the subrecipients and the effect of subrecipient activities on the pass-through entity.

Pass-through entities can no longer rely on single audit reports to monitor subrecipients that expend less than \$300,000 annually. However, A-133 allows pass-through entities to monitor those subrecipients through limited-scope audits. During the planning phase of an A-133 audit, the auditor should consider whether it may be able to assist the auditee with that process.

A limited-scope audit is an agreed-upon procedures engagement performed in accordance with GAAS or the Statements on Standard for Attestation Engagements that is paid for and arranged by the pass-through entity and that addresses only certain compliance requirements. Those compliance requirements are activities allowed or unallowed; allowable costs and cost principles; eligibility; matching, level of effort, and earmarking; and reporting. In this situation, the pass-through entity must contract for the engagement; it is not acceptable for the pass-through entity to require a subrecipient to contract for the engagement. Also, not all subrecipients that are not subject to an A-133 audit may need an agreed-upon procedures engagement. A cyclical approach to such engagements or other monitoring procedures might be more cost-beneficial.

Also, although A-133 does not directly apply to non-U.S.-based and for-profit entities expending federal awards received indirectly as a subrecipient, it does provide that a pass-through entity is responsible for establishing requirements to ensure compliance by those types of subrecipients. Pass-through entities may apply different monitoring procedures to those types of subrecipients because the use of single audits as a monitoring tool is not available.

Does the Auditee Meet the Criteria for a Low-Risk Auditee?

A-133 provides the potential for reduced audit coverage (“percentage-of-coverage rule”) of federal expenditures for entities that qualify as a low-risk auditee. If an auditee is determined to be low-risk, the auditor need only audit as major programs federal programs with expenditures that in the aggregate encompass at least 25 percent of total federal expenditures, rather than the minimum of 50 percent coverage generally required by A-133. To be a low-risk auditee, an entity must meet the following conditions for the preceding two audit periods:

- Single audits performed
- Unqualified opinions on the financial statements and the schedule of expenditures of federal awards (If the opinions were other than unqualified, a cognizant or oversight agency for audit may judge that the condition does not affect the management of federal awards and provide a waiver. A pass-through entity cannot provide such a waiver.)
- No material weaknesses in internal control at the financial statement level (Once again, a cognizant or oversight agency may provide a waiver for such a condition.)

- No audit findings of the following types in programs during the audit period that they were classified as Type A programs—material weaknesses in internal control, material noncompliance, or known or likely questioned costs greater than 5 percent of expenditures for that Type A program

A low-risk auditee can be an entity that receives either annual or biennial audits. An entity that has biennial audits does not qualify as a low-risk auditee unless agreed to in advance by the cognizant or oversight agency for audit. For entities with annual audits, the criteria have to be met for the previous two fiscal years. For entities with biennial audits, the criteria have to be met for the previous two audit periods—a total of four fiscal years.

Auditors should note that the application of the percentage-of-coverage rule is the final step in the auditor's determination of major programs. (See "Selecting Major Programs," later in this chapter.)

A checklist to assist auditors in determining whether an entity qualifies as a low-risk auditee is presented as a Practice Aid to this practice guide.

Auditors are required to document in their working papers the evaluation of whether an auditee meets the criteria for a low-risk auditee. This evaluation and documentation is needed even if the auditor does not use a risk-based approach to selecting major programs in a particular year because the reduced percentage-of-coverage rule also applies when the auditor selects major programs using a dollar threshold. Further, an auditee's status as low-risk or not is reported in (1) the summary of auditor's results in the schedule of findings and questioned costs and (2) the data collection form.

Auditee Reporting Responsibilities

In the planning phase of the audit, the auditor should make sure that the auditee understands and is prepared to meet its reporting obligations under A-133. These reporting obligations require that the auditee prepare the financial statements, the schedule of expenditures of federal awards, the summary schedule of prior audit findings, and the corrective action plan as well as complete a portion of the data collection form.

Communication With Federal Agencies and Pass-Through Entities

A-133 assigns certain responsibilities to cognizant or oversight agencies for audit, federal awarding agencies, and pass-through entities. It also establishes definitions to allow the auditor and auditee to identify the auditee's cognizant or oversight agency for audit. During the planning phase of the audit, the auditor should consider the need to establish communication with one or more of those agencies or entities to, among other things, clarify the audit requirements concerning the federal awards they have provided or the requirements of A-133. See chapter 3 of SOP 98-3 for a list of matters that could be discussed with federal agencies or pass-through entities.

Understanding Internal Control and Compliance Requirements

A-133 imposes the requirements of GAAS and GAS (see chapter 3 of SOP 98-3 for a discussion of the additional GAS documentation requirement for internal control) for the auditor to obtain an understanding of internal control related to the financial statements (internal control over financial reporting). In addition, A-133 requires the auditor to—

1. Perform procedures to obtain an understanding of internal control over federal programs (internal control over compliance) sufficient to plan the audit to support a low assessed level of control risk for major programs.
2. Plan and perform 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, unless the internal controls are likely to be ineffective.

When planning the procedures related to the consideration of internal control over financial reporting and over compliance, the auditor also should consider the reporting requirements—namely, reports on internal control related to the financial statements and on compliance with major programs.

The reports are to include the following:

1. Scope of testing of internal control
2. The results of the tests
3. Where applicable, reference to a separate schedule of findings and questioned costs

A discussion of planning and performing tests of internal control over compliance with major program requirements is presented in chapter 5 of this practice guide.

In planning the single audit, the auditor should identify the compliance requirements related to major programs for which internal control and compliance testing will be performed. In doing this, the auditor should consult the *Compliance Supplement*, which is summarized in chapter 2 of this practice guide. The auditor's process will differ somewhat depending on whether the auditee's major programs are included in the *Compliance Supplement*. If they are, the auditor should identify the following:

- Which of the fourteen types of compliance requirements may apply to the program by referring to the matrix of compliance requirements in part 2 of the *Compliance Supplement*
- The nature of the compliance requirements applicable to the program and audit objectives and suggested audit procedures for each type of compliance requirement by referring to part 3 of the *Compliance Supplement*
- The specific compliance criteria (such as eligibility and reporting) applicable to the program by referring to part 4 or, for R&D and SFA, part 5 of the *Compliance Supplement*
- Whether additional or different compliance requirements apply for each major program by, for example, consulting the applicable laws, regulations, and provisions of contracts and grant agreements; the auditee; the federal agency or pass-through entity; program handbooks and procedures manuals; and correspondence between the auditee and the federal agency or pass-through entity
- The compliance requirements that could have a direct and material effect on each major program

This final item is important because A-133 requires the testing of internal control over compliance and substantive tests of compliance only on those requirements that could have a direct and material effect on the program. For example, if an auditee's program has no procurement contracts for goods or services in excess of \$100,000 and makes no sub-awards to subrecipients, procurement and suspension and debarment and subrecipient monitoring requirements could have no direct and material effect on the auditee's program.

If the auditee's major programs are not included in the *Compliance Supplement*, the auditor should—

- Identify the compliance requirements that apply to each major program by consulting the applicable laws, regulations, and provisions of contracts or grant agreements; the auditee; the federal agency or pass-through entity; program handbooks and procedures manuals; correspondence between the auditee and the federal agency or pass-through entity; the Catalog of Federal Domestic Assistance; and other sources as discussed in part 7 of the *Compliance Supplement*.⁴

⁴ The auditor should consider the guidance in a program-specific audit guide or other audit guidance issued by the federal agency as well as consider whether guidance in the OMB-issued *Compliance Supplement* is helpful and has continuing relevance.

- Identify the compliance requirements that could have a direct and material effect on each major program, that are susceptible to testing, and for which testing adds value.⁵
- Relate each of the identified compliance requirements to a type of compliance requirement listed in part 3 of the *Compliance Supplement*.

A case study illustrating the identification of compliance requirements is presented as a Practice Aid to this practice guide.

During the planning phase of the audit, the auditor also should consider the timing of the testing of internal control over compliance and the substantive tests of compliance. Such timing is a matter of professional judgment and the circumstances surrounding the engagement. Performing tests at interim dates may permit early consideration of significant matters affecting compliance and federal expenditures. Much of the audit planning, including obtaining an understanding of and performing tests of internal control over compliance and performing substantive tests of compliance, can be conducted before year-end.

If the auditor obtains evidential matter about the design and operation of internal control over compliance with federal programs during an interim period, he or she should determine what additional evidential matter should be obtained for the remaining period. In making that determination, the auditor should consider the following:

- The significance of the compliance requirement
- The specific internal control components that were evaluated during the interim period
- The degree to which the effectiveness of the design and operation were evaluated
- The results of the interim tests of internal control
- The length of the remaining period
- Additional evidential matter obtained resulting from tests performed during the remaining period, including evidence of whether changes in internal control and personnel have occurred

Before performing interim tests of compliance, the auditor should consider the cost-effectiveness of interim testing. For example, if a sample cannot be restricted to cover the period between the interim tests and year-end, interim testing may not be cost-effective. Substantive compliance tests should be designed to cover the remaining period in such a way that the assurance from those tests and the interim tests together achieve the test objectives.

Preliminary Assessment of Audit Risk

GAAS and GAS require that the auditor obtain an understanding of the possible effect of the laws, regulations, and provisions of contracts or grant agreements that could have a direct and material effect on the financial statements. The auditor's assessment of the risk of noncompliance related to the financial statements is discussed in the applicable AICPA Audit and Accounting Guides and chapter 4 of SOP 98-3.

For federal purposes, A-133 expands the auditor's responsibility for evaluating compliance to include those laws, regulations, and provisions of contracts or grant agreements that could have a direct and material effect on each of its major federal programs.

Audit risk in an A-133 audit of compliance with the requirements of major federal programs—the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on compliance—is composed

⁵ The auditor is expected to test compliance only for those requirements that he or she can evaluate against objective criteria and for which he or she reasonably can be expected to recognize noncompliance. The auditor is not expected to test compliance with requirements that the federal agency or pass-through entity should have the ability to verify in the normal course of administering the program, such as compliance with report submission deadlines.

of inherent risk, control risk, and detection risk. Those risks are defined as follows:

1. Inherent risk: The risk that material noncompliance with requirements applicable to a major federal program could occur, assuming there is no related internal control
2. Control risk: The risk that material noncompliance that could occur in a major federal program will not be prevented or detected on a timely basis by the entity's internal control over compliance
3. Detection risk: The risk that an auditor's procedures will lead him or her to conclude that noncompliance that could be material to a major federal program does not exist when in fact such noncompliance does exist

For purposes of audit planning, the auditor needs—for example, through discussions with the auditee, observation of internal control procedures, and knowledge gained from prior audit experience—to establish preliminary assessments of inherent and control risk. Those preliminary risk assessments should be updated throughout the audit as the auditor performs tests of internal control over compliance and substantive tests of compliance. The preliminary risk assessments will be used to determine the nature and extent of tests of internal control over compliance. The auditor will then use the results of that internal control testing to update the risk assessments and to determine the nature, timing, and extent of substantive compliance tests to be performed. For example, more compliance testing procedures normally would be performed if the inherent and control risks were high than if those risks were low.

Materiality

Materiality is a significant matter that should be considered in planning the single audit. SAS No. 47 provides guidance on the auditor's consideration of materiality when planning and performing an audit of financial statements in accordance with GAAS. Materiality as it relates to the financial statement audit is further discussed in the applicable AICPA Audit and Accounting Guides.

Chapter 4 of GAS states:

Auditors' consideration of materiality is a matter of professional judgement and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgements 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.

In auditing compliance with requirements governing major programs in accordance with A-133, the auditor's consideration of materiality differs from that in an audit of financial statements. In an audit of financial statements, materiality is considered in relation to the level at which the financial statements are being audited. In an audit of an organization's compliance with applicable requirements in accordance with A-133, however, materiality is considered in relation to each major program. Each major program may have a different materiality level, which generally would be lower than the materiality level of the financial statement audit. In planning the single audit, auditors should consider the level at which noncompliance with federal program requirements would be material to their opinions on the financial statements and on compliance with major federal programs.

In addition to expressing those opinions, A-133 requires auditors to report audit findings for—

1. Material noncompliance with the laws, regulations, and provisions of contracts or grant agreements related to a major program. For purposes of reporting an audit finding, materiality is in relation to one of the following:

- a. Type of compliance requirement for a major program
 - b. An audit objective identified in the *Compliance Supplement*
2. Known and likely questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program
 3. Known questioned costs that are greater than \$10,000 for a program that is not audited as major

Thus, materiality for purposes of reporting audit findings generally is at a lower level than for purposes of planning and performing the audit or for expressing opinions on the financial statements or on compliance with major programs.

The auditor should use professional judgment in determining materiality relative to each major program for purposes of his or her opinion on compliance. The auditor might consider, for example, a possible materiality level that is a percentage of the federal awards expended for a program during the year. The determination of materiality might differ for each client and for each major program, depending, for example, on the nature of the program, the control environment, and the auditor's risk assessments.

Noncompliance with requirements that relate to individual transactions is easier to quantify than noncompliance with requirements that contain minimum or maximum amounts or those that relate to performing a function or procedure. For example, amounts charged to federal programs that do not comply with applicable cost principles can be quantified. However, it may be difficult to quantify the amount of noncompliance relating to financial reporting or subrecipient monitoring.

To illustrate, the auditor may find that a pass-through entity failed on one occasion to provide a subrecipient with federal award information owing to unusual circumstances. Using professional judgment, the auditor may conclude that the finding is immaterial based on the amount provided to the subrecipient and the circumstances. However, if a pass-through entity consistently failed to provide each of its subrecipients with federal award information, including compliance requirements, such noncompliance generally would be considered material in relation to the type of compliance requirement (subrecipient monitoring) and, therefore, be reported as an audit finding. The auditor also would consider whether a reportable condition (and possibly a material weakness) in internal control over compliance existed and should be reported. The auditor would consider the effect, if any, that such noncompliance has on his or her opinions on the financial statements and on compliance with major programs.

See also the discussion of the relationship of materiality to reporting under A-133 in chapter 3 of SOP 98-3.

Initial-Year Audit Considerations

An auditor accepting, or contemplating accepting, an engagement in which another auditor audited the federal awards of the preceding period is guided by SAS No. 84, *Communications Between Predecessor and Successor Auditors*. The successor auditor should review the predecessor auditor's working papers during the planning phase of the audit. If the federal awards have not previously been audited, the auditor should discuss with the auditee and the cognizant or oversight agency for audit or pass-through entity the need to perform any audit work for the prior unaudited periods. If such additional work is not required, testing for the prior unaudited period would be limited to balances as of the end of that unaudited period.

A-133 permits auditors to use a dollar threshold rather than a risk-based approach to select major programs for first-year audits. (A first-year audit is the first year the entity is audited under A-133 or the first year of a change of auditors.) However, that election for a first-year audit may not be used more often than once every three years. The auditor should determine whether the auditee's single audit was subject to the first-year exception in the past two years and, if not, whether he or she wishes to use a dollar threshold in the current year. In considering this option, auditors could evaluate the potential major programs under each approach, the auditor's familiarity with the auditee and with the potential major programs, and the auditee's prior single audit findings. Although the selection of the option is the auditor's choice, the auditor should consider

consulting with the auditee in this matter; because of issues in particular programs, the auditee may want the auditor to use the risk-based approach. Also, the percentage-of-coverage rule—whether 25 percent for a low-risk auditee or 50 percent for others, as discussed elsewhere in this chapter—applies even if the auditor is using a dollar threshold to select major programs.

Report Submission Deadlines

In planning the timing of the single audit, the auditor should consider the report submission deadline. A-133 requires the auditee to submit the single audit reporting package the earlier of thirty days after receipt or nine months after the end of the audit period.

Joint Audits and Reliance on Other Auditors

A-133 states that whenever possible, auditees are to make positive efforts to use small businesses, minority-owned firms, and women's business enterprises in procuring audit services. Therefore, a principal auditor may conduct the audit on a joint venture or subcontract basis with such a firm. In addition, the audit of a governmental entity may be jointly conducted with a government audit agency.

Before entering into an agreement to perform a joint audit or to subcontract with another firm, the auditor should consider SAS No. 64, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543), and Ethics Interpretation No. 101-10, "The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements," of ET section 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101.10) The auditor also should plan to perform procedures appropriate to the use of other auditors, including the following:

- Obtaining separate audited financial statements and schedules of expenditures of federal awards for each component unit
- Confirming the other auditor's independence and obtaining representations that the other audit organization and its personnel have met the requirements of GAS, including continuing professional education (CPE), internal quality control, and external triennial quality control reviews
- Deciding whether to refer to the work of the other auditor in the audit reports

If part of the single audit is performed by governmental auditors, the auditors should be satisfied that the government auditors are free from organizational, personal, and external impairments to independence and that they maintain an independent attitude and appearance as required by GAS.

Auditee Locations to Visit

During the planning phase of a financial statement audit, the auditor should determine the locations where the auditee performs accounting functions and maintains accounting records. In addition, when planning the A-133 audit, the auditor should determine whether the auditee administers major programs at multiple locations. The auditor may wish to consider the following in determining whether to visit a satellite location:

- The materiality of the portion of the federal programs administered at the location
- The level of central office oversight of the functions at a satellite location
- The results of prior audits, if any, at that location
- The preliminary assessments of inherent risk and control risk for that program
- The extent and nature of the records maintained at the location

Audit Approach, Personnel, and Programs

The auditor should design an efficient audit approach when planning the single audit. Audit work is most efficient if it is designed to avoid repetitive procedures. Therefore, auditors should consider the following efficiencies in determining the nature, timing, and extent of the single audit work to be performed:

- The financial statement and single audits could be planned at the same time. Samples selected for financial statement testing could also be used for single audit testing if the internal controls over financial reporting also process federal program transactions.
- If otherwise consistent with the major program selection criteria of A-133, auditors could select as major those programs with which they have recent prior audit experience as well as programs that are included in the *Compliance Supplement*.
- If internal auditors are involved in monitoring program compliance, the auditor could consider whether examining that work could bring efficiencies to the single audit.
- If the auditee administers more than one major program using the same internal control system, transactions of those programs could be combined for selecting test samples.
- A single sample of major program transactions could be used for both internal control and compliance testing (dual-purpose testing).
- Sample sizes for substantive tests of compliance can be reduced if testing of internal control over compliance supports a low assessed level of control risk.
- The auditor could use standardized checklists, such as those provided as Practice Aids in this practice guide.

Engagement planning also should include procedures for assigning personnel to the engagement. The procedures established should provide reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances and that those persons are appropriately supervised. Further, care should be taken to ensure that audit personnel meet the biennial CPE requirements in *Government Auditing Standards*, chapter 3.

A survey of government audits performed by the AICPA Federal Assistance Audit Quality Task Force identified common attributes associated with quality federal financial assistance audits. The study results established a strong link between quality audits and characteristics that included an audit team that obtained a large amount of biennial continuing professional education related to federal financial assistance audits, a CPA firm partner who spent a large percentage of his or her current-year time on federal financial assistance audits, an in-charge auditor who was a CPA, and review by a second partner.⁶

As part of the planning phase of the audit, the auditor should develop audit programs. The auditor can use the electronic versions of the *Compliance Supplement*, which are available at the sources indicated at the appendix to the Practice Aids, to develop those audit programs.

NON-FEDERAL GRANTS AUDITS AND OTHER CLIENT SERVICES

In addition to the A-133 and pass-through entity requirements imposed on federal awards, there also may be requirements imposed by states, local governments, and other entities that make non-federal grants to governments and not-for-profit organizations. In connection with the financial statement audit, the auditor should obtain an understanding of reporting and compliance requirements that relate to those non-federal grants that could have a direct and material effect on the financial statements being audited. The auditor

⁶ *Journal of Accountancy*, AICPA, January 1995, pp. 61–68.

should consider performing the following additional procedures relating to those non-federal grants:

1. Inquire of management about the grantor's compliance requirements applicable to the entity.
2. Inquire of appropriate state or local government audit oversight organizations about audit requirements applicable to the entity.
3. When the engagement includes auditing compliance with a non-federal grant award, read the grant agreements and any amendments and obtain any applicable audit guidance pertaining to the grant from the grantor agency, including any audit guides, administrative rulings, and the like.

Auditees also may request separate A-133 audits of component units or other services, such as separate audits of pension trust funds or agreed-upon procedures related to compliance with debt covenants. Auditors should consider those additional services in the planning process.

SELECTING MAJOR PROGRAMS

A-133 requires that, except for first-year audits as discussed earlier in this chapter, auditors should select major programs using a risk-based approach. That approach is a four-step process that distinguishes between programs based on size, risk assesses the programs, selects major programs, and tests for compliance with the percentage-of-coverage rule. An illustrative worksheet for determining major programs using the risk-based approach is a Practice Aid to this practice guide. A case study illustrating the selection of major programs is presented as a Practice Aid.

Step 1: Identify Type A and Type B Programs

A-133 requires auditors to distinguish between Type A (larger) and Type B (smaller) programs based on a dollar threshold for Type A programs that varies depending on the auditee's total federal expenditures as follows:

<u>TOTAL FEDERAL EXPENDITURES</u>	<u>TYPE A THRESHOLD</u>
≥\$300 thousand and ≤\$10 million	\$300 thousand
>\$10 million and ≤\$100 million	3 percent (0.03) of awards expended
>\$100 million and ≤\$1 billion	\$3 million
>\$1 billion and ≤\$10 billion	.3 percent (0.003) of awards expended
>\$10 billion and ≤\$20 billion	\$30 million
>\$20 billion	.15 percent (0.0015) of awards expended

All programs not classified as Type A programs using the Type A threshold are classified as Type B programs. A-133 provides that loan and loan guarantee programs should not significantly affect the number or size of Type A programs. If they would, they should be designated as Type A programs and their values should be excluded in calculating other Type A programs. (This process is illustrated in the case study in this practice guide and in chapter 7 of SOP 98-3.)

Clusters of programs should be considered as one program for purposes of identification as a Type A or Type B program (as well as for the subsequent risk assessment).

For biennial audits, the determination of Type A and Type B programs is based on federal expenditures during the two-year period. For example, if a biennial auditee expended \$90 million in each year of the biennium, Type A programs would be those exceeding \$3 million because total federal expenditures for the biennium were \$180 million (and thereby greater than \$100 million but less than \$1 billion).

The schedule of expenditures of federal awards (or a draft of it) should be made available by the auditee for audit planning purposes. If the schedule is initially provided in draft form, the auditor should be careful to monitor changes to that schedule that could result in changes to the Type A threshold and thus the identification of Type A programs. Such changes can affect the selection of major programs by, for example, changing a high-risk Type B program that was not selected as a major program to a Type A program that should be audited as a major program. (See the further discussion of audit procedures relating to the schedule of expenditures of federal awards in chapter 6 of this practice guide.)

The auditor also should make a preliminary assessment that the auditee has a proper understanding of the federal expenditures to include in the schedule—in terms of both the timing of expenditure recognition and the inclusion of noncash transactions. Further, federal expenditures for purposes of the schedule should include program expenditures made from program income that reduce federal awards or increase the program budget but not program income that is used to meet matching requirements (which is considered a non-federal expenditure). Because federal expenditures of program income for some federal programs could be sizeable in relation to other federal expenditures for those programs, auditors should make sure that federal expenditures from program income have been appropriately included during the initial major program selection process. A checklist of the required information for the schedule of expenditures of federal awards and a checklist of audit procedures for the review of the schedule of expenditures of federal awards are Practice Aids to this practice guide.

Step 2: Risk Assess Type A Programs

The auditor should assess each Type A program as high- or low-risk using criteria established in A-133.⁷ For a Type A program to be low-risk, it must have (1) been audited as major in one of the two preceding fiscal years (in the most recent audit period in the case of biennial audits) and (2) not had a reportable condition in internal control or material noncompliance with laws, regulations, or the provisions of contracts or grant agreements during the most recent audit. Further, the federal awarding agency must not have notified the auditee that the program should be considered high-risk in accordance with the provisions of § ____ .520(c)(2), which permits OMB to approve a federal awarding agency's request that a Type A program at certain recipients not be considered low-risk. (OMB has not yet made any such approvals.) If after these initial criteria are considered, the Type A program has not been found to be high-risk, the auditor should assess the following A-133 criteria and use professional judgment to determine whether the program is high- or low-risk. (The presence of the condition is an indicator of higher risk and the nature and preponderance of these conditions would indicate a high-risk program.) These criteria should be evaluated in the context of the most recent audit.

- The program had known or likely questioned costs exceeding \$10,000 for a type of compliance requirement when previously audited as a major program or known questioned costs exceeding \$10,000 when not audited as major program.
- The program had known fraud.
- There was material misrepresentation of the status of a prior audit finding.
- Recent monitoring by the federal agency or pass-through entity indicates significant problems.
- The federal agency indicates this program is high-risk in the *Compliance Supplement*.
- The program has inherent risk as evidenced by—
 - Complex, new, or recently changed regulations.

⁷ A-133 provides for identifying whether Type A programs are low-risk. Type A programs that are not identified as low-risk during the risk assessment process may not, technically, be high-risk programs; they have only a higher level of risk than low. However, for purposes of simplicity, this practice guide uses the term *high-risk* to refer to Type A programs that are not identified as low-risk during the risk assessment process.

- Significant amounts spent on contracts for goods and services.
- Eligibility requirements.
- The fact that this is the first or last year of the program at the auditee.
- Follow-up on prior audit findings indicates continuing compliance problems.
- The program has experienced changes in personnel or systems.

A checklist for risk assessing Type A programs is a Practice Aid to this practice guide.

Step 3: Risk Assess Type B Programs

Next, the auditor may need to assess Type B programs as high- or low-risk using criteria established in A-133.⁸ The number of Type B programs that need to be risk assessed depends on the number of low-risk Type A programs and the replacement option selected by the auditor, as discussed in step 4, below. If the auditee has no low-risk Type A programs, there are no Type A programs to be replaced, and therefore, no high-risk Type B programs need to be identified. The auditor need not risk assess any Type B programs in this situation. Also, if the auditee has no Type A programs, the auditor need not risk assess any Type B programs. However, the percentage-of-coverage rule discussed in step 4 should be met in all circumstances.

Also, A-133 does not require smaller Type B programs to be risk assessed. The auditor is required to consider performing risk assessments only on Type B programs that exceed the larger of \$100,000 or .3 percent (.003) of awards expended if total federal expenditures are less than or equal to \$100 million. If total federal expenditures are greater than \$100 million, the assessments, if necessary, are required to be performed only on programs with expenditures that exceed the larger of \$300,000 or .03 percent (.0003) of awards expended.

A-133 provides certain individual criteria that would, by themselves, indicate that a Type B program is high-risk. Those criteria are:

- Known reportable conditions in internal controls
- Weaknesses in internal control related to—
 - The control environment
 - The auditor’s expectation for management adherence to program requirements
 - The competence and experience of personnel
 - Multiple internal control structures
 - A weak monitoring system when there is extensive use of subrecipients
 - Substantial or complex computer processing
- Prior audit findings, especially when the situations could have a significant effect on the program or have not been corrected
- Recent monitoring by the federal agency or pass-through entity that indicates significant problems
- The federal agency has notified auditee the program should be considered high-risk

If, after these initial criteria are considered, the Type B program has not been found to be high-risk, the auditor should assess the following A-133 criteria and use professional judgment to determine whether the

⁸ A-133 provides for identifying whether Type B programs are high-risk. Type B programs that are not identified as high-risk during the risk assessment process may not, technically, be low-risk programs; they may have only a lower level of risk than high. However, for purposes of simplicity, this practice guide uses the term *low-risk* to refer to Type B programs that are not identified as high-risk during the risk assessment process.

program is high- or low-risk. (The presence of the condition is an indicator of higher risk and the nature and preponderance of these conditions would indicate a high-risk program.)

- The program was not recently audited as a major program.
- The federal agency indicates this program is high-risk in the *Compliance Supplement*.
- The program has inherent risk as evidenced by—
 - Complex, new, or recently changed regulations.
 - Significant amounts spent on contracts for goods and services.
 - Eligibility requirements.
 - The fact that this is the first or last year of the program at the auditee.
- The program has larger expenditures than other Type B programs.

A checklist for risk assessing Type B programs is a Practice Aid to this practice guide.

Step 4: Select Major Programs

The auditor now selects major programs. All high-risk Type A programs are major programs. In addition, high-risk Type B programs also may be major programs. A-133 provides the auditor two alternatives for replacing low-risk Type A programs and designating high-risk Type B programs as major. The option selected is the auditor's choice, with no criteria established for choosing one over the other. Also, the option selected may differ from year to year without justification required.

- With option 1, the auditor selects at least one-half of the high-risk Type B programs as major programs, up to the number of low-risk Type A programs
- With option 2, the auditor selects one high-risk Type B program for each low-risk Type A program, up to the number of high-risk Type B programs

In using option 1, the term *at least one-half* requires the auditor to round the result of the calculation up if the number of high-risk Type B programs is odd. For example, if there are five high-risk Type B programs, "at least one-half of them" is three.

When there are low-risk Type A programs, option 1 requires the auditor to risk assess all Type B programs, whereas option 2 requires the auditor to risk assess Type B programs only until he or she has identified up to the same number of high-risk Type B programs as there are low-risk Type A programs. However, in some cases, selecting option 1 may result in selecting fewer Type B programs as major programs than would option 2.

For example, assume that an auditee has four low-risk Type A programs. Option 1 requires the auditor to risk assess all Type B programs. If six Type B programs are found to be high-risk, only three need to be selected as major programs. Option 2 requires the auditor to risk assess the Type B programs until he or she finds four that are high-risk; those four are then selected as major programs. In this example, depending on the order in which the auditor considers the Type B programs for risk assessment, the auditor may have less effort in selecting major programs using option 2 but would have more effort in auditing the four programs rather than the three using option 1.

The high-risk Type B programs that the auditor selects as major are based only on the auditor's judgment, except that 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 time.

Further, auditors must select as a major program those programs a federal agency or pass-through has requested be audited as a major. §____.215(c) permits a federal agency or pass-through entity to request an

auditee to have a particular federal program audited as a major program in lieu of the federal agency or pass-through entity conducting or arranging for an additional audit. If the program would not otherwise be audited as a major program using the risk-based audit approach, the federal agency or pass-through entity has to agree to pay the full incremental cost of the audit of the program. That program, like all major programs, is used in meeting the percentage-of-coverage rule.

Finally, A-133 requires the auditor to select major programs that encompass at least 50 percent of total federal expenditures. This percentage is reduced to 25 percent for low-risk auditees, as previously discussed in this chapter. A-133 does not establish criteria for selecting additional programs as major programs for this purpose. If the auditor needs to identify additional major programs for this percentage-of-coverage rule, he or she may consider various factors, such as the following:

- The auditor's familiarity with the potential additional major programs
- The inclusion of potential additional major programs in the *Compliance Supplement*
- The size of the potential additional major programs (that is, larger programs will more quickly achieve the percentage-of-coverage rule)
- The fact that Type A programs are required to be audited as major at least every three years
- Auditee requests that particular programs be audited

Auditors should be careful to note that the percentage-of-coverage rule—whether 25 percent for a low-risk auditee or 50 percent for others—are coverage minimums, not maximums. Specifically, for a low-risk auditee, if the selection of major programs using A-133 criteria indicates that 20 percent of the auditee's total federal expenditures were made in those major programs, the auditor must select one or more additional federal programs as major until the percentage equals or exceeds 25 percent. If, on the other hand, the selection of major programs using A-133 criteria indicates that 40 percent of the auditee's total federal expenditures were made in those major programs, the auditor may not set aside programs that were selected as major to reduce the coverage to 25 percent.

In performing risk assessments and selecting major programs, A-133 provides that as long as the risk assessment was conducted in accordance with the A-133 criteria and that assessment is documented in the working papers, the auditor's judgment in applying the risk-based approach will be presumed correct. Challenges to that judgment by federal agencies or pass-through entities will be only for clearly improper use of the A-133 criteria. However, A-133 permits federal agencies and pass-through entities to provide auditors guidance about the risk of a particular program and requires the auditor to consider that guidance in determining major programs for uncompleted audits.

CHAPTER 5: Internal Control

In performing a single audit, the auditor considers and reports on the auditee's internal control over financial reporting as required by generally accepted auditing standards (GAAS) and *Government Auditing Standards* (GAS) (internal control over financial reporting) as well as on its internal control over compliance with requirements that could have a direct and material effect on major federal programs as required by Office of Management and Budget (OMB) Circular A-133 (A-133) (internal control over compliance). This chapter discusses professional standards for considering and reporting on internal control over financial reporting as well as the way to plan and perform tests of internal control over compliance. A case study illustrating the auditor's consideration of and reporting on an auditee's internal control over compliance is a Practice Aid to this practice guide.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Statement on Auditing Standards (SAS) No. 55,¹ *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), requires the auditor to obtain an understanding of internal control sufficient to plan the audit and to assess control risk for the assertions embodied in the financial statements.

Internal control is defined in SAS No. 55² (as well as in A-133) as 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:

1. Reliability of financial reporting
2. Effectiveness and efficiency of operations
3. Compliance with applicable laws and regulations

Those control objectives are what an entity strives to achieve and have different purposes. Generally, the controls relevant to an audit of financial statements are those that pertain to the objective of reliable financial reporting. However, controls that pertain to the operational and compliance objectives also may be relevant to an audit of financial statements to the extent they affect data that 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 as *internal control over financial reporting*.

Control risk is defined in SAS No. 55³ 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. Therefore, *control risk related to financial reporting* is the risk related to material misstatements in those statements. *Assessing control risk related to financial reporting* is the process of evaluating whether the auditee's internal control will prevent or detect material misstatements in the financial statements. The auditor uses his or her knowledge of internal control over financial reporting and the assessed level of control risk related to financial

¹ The AICPA Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*. SAS No. 94 amends SAS No. 55, as amended, to provide guidance to auditors about the effect of information technology on internal control and on the auditor's understanding of internal control and assessment of control risk. SAS No. 94 is effective for audits of financial statements for periods beginning on or after June 1, 2001, with earlier application permitted.

² See footnote 1.

³ See footnote 1.

reporting to determine the nature, timing, and extent of substantive tests for assertions relevant to the financial statements.

In audits of financial statements, including those performed as part of a single audit, an auditor's understanding of internal control over financial reporting involves knowledge both about the design of controls, including those that are relevant to compliance with laws and regulations that could have a direct and material effect on the determination of financial statement amounts, and about whether those controls have been placed in operation. However, GAAS does not require an auditor to determine whether internal control is operating effectively. To obtain knowledge about whether controls have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the control was applied, the consistency with which it was applied, and who applied it. For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on. GAAS does not require the auditor to obtain knowledge about operating effectiveness as part of understanding of internal control.

SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), provides guidance on identifying and reporting conditions that relate to an entity's internal control observed during an audit of financial statements in accordance with GAAS. SAS No. 60 requires auditors to report to the audit committee or to an individual of equivalent authority and responsibility reportable conditions in internal control over financial reporting—those conditions that in their judgment represent significant deficiencies in the design or operation of the internal control that could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. A checklist of examples of possible reportable conditions in internal control over financial reporting is presented as a Practice Aid to this practice guide.

GAS requires the auditor to perform one additional field work standard related to internal control over financial reporting beyond that required in an audit conducted in accordance with GAAS. That additional standard (in chapter 4 of GAS) requires the auditor, when planning the audit, to document in the working papers (a) the basis for assessing control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems; and (b) consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptance level. This additional standard does not increase the auditor's responsibility for testing controls. However, it may require additional documentation. If control risk is assessed at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems, the auditor should document in the working papers the basis for that conclusion by addressing (a) the ineffectiveness of the design or operation of the controls or both, or (b) the reasons why it would be inefficient to test the controls. This documentation should address: (a) the rationale for determining the nature, timing, and extent of planned audit procedures; (b) the kinds and competence of available evidential matter produced outside a computerized information systems; and (c) the effect on the audit opinion or report if evidential matter to be gathered during the audit does not afford a reasonable basis for the auditor's opinion on the financial statements.

Also, chapter 5 of GAS includes reporting requirements beyond those set forth in SAS No. 60. Under GAS, the auditor is to report all reportable conditions and separately identify those reportable conditions that are individually or cumulatively material weaknesses.⁴ GAS also requires that when auditors issue separate reports on compliance and internal control over financial reporting, the report on the financial statements should state that they are issuing those additional reports and that those separate reports are an integral part of

⁴ A material weakness in internal control over financial reporting 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 errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

the audit in accordance with GAS and should be read along with the auditors' report on the financial statements. A-133 requires the report on internal control over financial reporting to describe the scope and results of the tests performed and, where applicable, to refer to the separate schedule of findings and questioned costs. (Auditors are not required to express an opinion on internal control over financial reporting.) See the discussion of the auditor's report on internal control over financial reporting in chapter 7 of this practice guide.

For further information and guidance on an auditor's responsibilities related to internal control over financial reporting, refer to GAAS, GAS, the AICPA Audit Guide *Consideration of the Internal Control Structure in a Financial Statement Audit*, the applicable AICPA industry Audit and Accounting Guides, and chapter 4 of Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.

INTERNAL CONTROL OVER COMPLIANCE

In addition to the consideration of internal control over financial reporting required by GAAS and GAS, A-133 requires auditors to perform procedures to obtain an understanding of internal control pertaining to the compliance requirements for federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. Those procedures have to be applied only to internal control over compliance requirements that could have a direct and material effect on the major programs (internal control over compliance). A-133 also requires auditors to plan and perform tests of internal control over compliance unless the internal control is likely to be ineffective in preventing or detecting noncompliance with those requirements. (See also the discussion of internal control over compliance in chapter 8 of SOP 98-3.)

A-133 defines *internal control pertaining to the compliance requirements for federal programs* as 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.
 - c. Demonstrate compliance with laws, regulations, and other compliance requirements.
2. Transactions are executed in compliance with—
 - a. The laws, regulations, and provisions of contracts or grant agreements that could have a direct and material effect on a federal program.
 - b. Any other laws and regulations that are identified in the *Compliance Supplement*.
3. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Control risk related to compliance is the risk that material noncompliance with requirements related to major programs could occur and not be prevented or detected on a timely basis by the auditee's internal control. *Assessing control risk related to compliance* is the process of evaluating whether the auditee's internal control will prevent or detect material noncompliance with the compliance requirements for each major program. The auditor uses his or her knowledge 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 major programs.

An auditor's understanding of internal control over compliance involves knowledge not only about the design of controls and whether those controls have been placed in operation, but also whether those controls are operating effectively. This final factor—determining whether controls are operating effectively—is provided for in the A-133 requirement for planning and testing internal control to support a low assessed level of control risk. Although a low assessed level of control risk is not defined—in GAAS, GAS, or A-133—the federal government wants auditors to test internal control over the compliance requirements related to major

programs unless those controls are likely to be ineffective. A-133 requires auditees to establish and maintain internal control over federal programs that provides reasonable assurance that it is managing federal awards in compliance with the laws, regulations, and provisions of contracts or grant agreements that could have a material effect on each of its federal programs. (The A-102 Common Rule and A-110 requirements for internal control over compliance are similar but more stringent because they refer to all compliance requirements, not only to those that could have a material effect on the programs.) A-133 requires auditors to—

1. Identify compliance requirements that could have a direct and material effect on an auditee's major programs.
2. Gain an understanding of the auditee's internal control over those compliance requirements to plan a low assessed level of control risk.
3. Assess control risk.
4. Document their understanding of internal control and their control risk assessments.

Except for the internal control that is likely to be ineffective in preventing or detecting noncompliance with compliance requirements that could have a direct and material effect on major programs, auditors should—

1. Perform tests of internal control.
2. Document the tests they performed and the results of those tests.

A-133 does not require the auditor to plan or perform tests of internal control over compliance if he or she determines that those controls are likely to be ineffective in preventing or detecting noncompliance, that is, if the auditor cannot achieve a low assessed level of control risk for a particular compliance requirement that could have a direct and material effect on a major program. When that is the case, the auditor must (1) assess control risk at maximum, (2) consider the effect of the ineffective control on the extent of substantive compliance testing, and (3) report a reportable condition or material weakness as an audit finding.⁵

In applying the provisions of A-133, ineffective internal control relates to individual compliance requirements for each major program. For example, controls over eligibility requirements may be ineffective because access to participant eligibility records is not limited to appropriate persons and there is no review or reperformance of eligibility determinations. The entity may nonetheless have sufficient controls over allowable costs. In this case, the auditor would be required to plan and perform tests of controls over allowable costs and consider reporting an internal control audit finding for the lack of control related to eligibility. The auditor in this example also would be required to assess the extent of procedures designed to test compliance with eligibility requirements. In most cases, the extent of testing would need to be expanded. (See also the discussion in chapter 8 of SOP 98-3.)

Because reportable conditions and material weaknesses for the purpose of reporting audit findings in accordance with A-133 are in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement*, the auditor may not be required to report an audit finding if a control that is likely to be ineffective is not material at either of those levels. For example, for the program

⁵ For purposes of the auditor's report in accordance with A-133, a reportable condition in internal control over compliance with major programs is a significant deficiency in the design or operation of the internal control over compliance that could adversely affect the entity's ability to administer a major federal program in accordance with applicable requirements of laws, regulations, contracts, and grants. A material weakness in internal control over compliance with major programs 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 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. However, for the purpose of reporting internal control audit findings in accordance with A-133, reportable conditions and material weaknesses are evaluated at a level lower than the major program level—they are evaluated in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement*. Also, reportable conditions may individually or cumulatively be material weaknesses, whether for purposes of the report on internal control over compliance or for internal control audit findings.

income type of compliance requirement, auditees must comply with requirements that specify the use of income that is directly generated by a program during the grant period. The audit objective identified in the *Compliance Supplement* is to determine whether program income is correctly recorded and used in accordance with the program requirements, the A-102 Common Rule, and A-110, as applicable. Suppose that an auditor assesses the control risk for an auditee's internal control over program income at the auditee's headquarters location as low, but finds that the internal control over program income at a satellite location is likely to be ineffective. However, the extent of program activities conducted at the satellite location, including those that generate program income, are not material to the program. In this situation, the auditor could conclude that the lack of control over program income requirements at the satellite location does not constitute a reportable condition for the purpose of reporting an audit finding.

The auditor has no responsibility under A-133 to obtain an understanding of internal control or to plan or perform any tests of controls over federal programs that are not determined to be major. However, a program that is not considered major still may be material to the financial statements. In this situation, the auditor may need to obtain an understanding of the internal control over the financial reporting relative to that program for the financial statement audit.

A flowchart of the process of considering internal control over compliance is shown as exhibit 5-1 at the end of this chapter.

A-133 requires a report on internal control over compliance that describes the scope and results of the tests performed and, where applicable, refers to the separate schedule of findings and questions costs. It does not require auditors to express an opinion on internal control over compliance. See the discussion of the auditor's report on internal control over compliance in chapter 7 of this practice guide.

Exhibit 5-2, at the end of this chapter, summarizes the internal control procedures and reports required by GAAS, GAS, and A-133.

INTERNAL CONTROL COMPONENTS

According to the Committee of Sponsoring Organizations of the Treadway Commission in its *Internal Control—Integrated Framework* (COSO Report), internal control consists of five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring. Part 6 of the *Compliance Supplement*, which auditors should consider consulting in planning and performing an A-133 audit, uses those five components to present the characteristics of internal control for the types of compliance requirements addressed in A-133 and the *Compliance Supplement*. SAS No. 55⁶ and the related AICPA Audit Guide *Consideration of Internal Control in a Financial Statement Audit* also incorporate those components of internal control.

The following defines the five components of internal control and discusses them in relation to compliance with federal program requirements.

Control Environment

The control environment sets the tone of an organization and influences the control consciousness of its personnel. It is the foundation for all other components of internal control, providing discipline and structure. The control environment relating to compliance with federal programs may include such factors as the following:

- Sense of conducting operations ethically, as evidenced by a code of conduct or other verbal or written directive
- Management's positive responsiveness to prior questioned costs and control recommendations

⁶ See footnote 1.

- Management respect for and adherence to program compliance requirements
- Clear definitions of key managers' responsibilities
- Managers with adequate knowledge and experience to discharge their responsibilities
- Staff who are knowledgeable about compliance requirements and who have been given the responsibility to communicate noncompliance to management
- Management commitment to competence, including ensuring staff receive adequate training to perform their duties
- Management support of adequate information and reporting systems

The applicability and importance of those factors are affected by various characteristics, such as the entity's size and structure. The extent to which the auditor needs to understand the control environment is a matter of professional judgment applied to facts and circumstances. For example, the auditor may choose to understand how the control environment factors may differ in an entity for a major program that is administered at multiple locations.

Risk Assessment

Risk assessment is the entity's identification and analysis of risks relevant to achievement of its objectives that forms a basis for determining how the risks should be managed. For example, risk assessment involves how an entity considers the possibility that unallowable costs could be charged to a federal program. Risk assessment relating to compliance with federal programs may include such factors as the following:

- Program managers and staff understand and have identified key compliance objectives.
- The organizational structure provides for identifying risks of noncompliance, such as the following:
 - Key managers have been given responsibility to identify and communicate changes.
 - Employees who require close supervision (for example, because of inexperience) are identified.
 - Management identifies and assesses complex operations, programs, or projects.
 - Management is aware of results of monitoring, audits, and reviews and considers related risk of noncompliance.
- Management has implemented a process to address changes that occur in program objectives and procedures.

Risk assessment does not necessarily mean that management institutes controls. Management may initiate plans, programs, or actions to address specific risks, or it may decide to accept a risk because the cost to implement control may exceed the benefits to be derived or other considerations. Risks such as the following can arise or change because of changes in the operating environment:

- New personnel
- New or changes in management information, accounting, and reporting systems
- Rapid growth and expansion in overall operations or in federal programs
- New technology
- New federal programs administered by the entity
- Restructuring of the entity
- New locations administering federal programs
- New subrecipients
- Changes in oversight by federal agencies and pass-through entities
- Changes in third-party contracts
- Changes in compliance requirements

An auditor generally uses inquiry to assess the extent to which an entity has placed a risk-assessment process in operation. However, an auditor also may obtain such information by reviewing such documentation as correspondence with federal agencies, pass-through entities, and subrecipients and minutes of board of directors and other meetings.

Control Activities

Control activities are the entity's policies and procedures that help ensure that management directives are carried out. Control activities relating to compliance with federal programs may include such factors as the following:

- Operating policies and procedures that are clearly written and communicated
- Procedures to implement changes in laws, regulations, guidance, and funding agreements affecting federal programs
- Management prohibition against intervention or overriding established controls
- Adequate segregation of duties between performance, review, and recordkeeping of a task
- Computer and program controls that include data entry controls, exception reporting, access controls, reviews of input and output data, and general and security controls
- Supervision of employees commensurate with their level of competence
- Personnel with adequate knowledge and experience to discharge responsibilities
- Equipment, inventories, cash, and other assets secured physically and periodically counted and compared to recorded amounts

In considering control activities for compliance, the auditor should consider such factors as the complexity of the compliance requirements and the processing, number, and materiality of transactions.

Information and Communication

Information and communication are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities. Information and communication relating to compliance with federal programs may include such factors as the following:

- An accounting system that provides for separate identification of federal and non-federal transactions and allocation of transactions applicable to both
- Adequate source documentation that supports amounts and items reported
- A recordkeeping system that ensures that accounting records and documentation are retained for the time period required by applicable program requirements
- Timely reports to managers for review and appropriate action
- Accurate information that is accessible to those who need it
- Reconciliations and reviews that ensure accuracy of reports
- Established internal and external communication channels, such as staff meetings, bulletin boards, memos, e-mail, surveys, and so forth
- Employees' duties and control responsibilities that are effectively communicated
- Channels of communication that allow people to report suspected improprieties
- Actions that result from the communications received
- Established channels of communication between pass-through entity and subrecipients

The auditor should consider obtaining sufficient knowledge of the compliance information system to understand:

- Significant transactions affecting compliance with laws, regulations, and the provisions of contracts or grant agreements.
- How those transactions are initiated.
- The records, supporting documents, computer media, and specific accounts involved in processing and reporting transactions.
- How the transactions are processed.
- The process used to prepare federal and other reports.

Communication includes both internal and external communications. Communication involves providing information to employees not only about their roles and responsibilities and about internal control, but also about the processing and results of transactions to allow those employees to ensure compliance. Communication also involves the flow of information between the entity and its funding sources and between the entity and its subrecipients. The provisions in A-133 for this type of external communication may result in increased communication between those parties as compared to the past.

Monitoring

Monitoring is a process that assesses the quality of internal control performance over time. Monitoring relating to compliance with federal programs may include such factors as the following:

- Ongoing monitoring that is provided through independent reconciliations, staff meeting feedback, supervisory review, and management review of reports
- Periodic site visits that are performed at decentralized locations (including subrecipients) and periodic determination of whether procedures are being followed as intended
- Follow-up on irregularities and deficiencies to determine the cause
- The performance of internal quality control reviews
- Management meetings with program monitors, auditors, and reviewers to evaluate the condition of the program and controls
- Routine internal audit tests for compliance with federal requirements

UNDERSTANDING AND TESTING INTERNAL CONTROL OVER COMPLIANCE

The auditor should obtain a sufficient understanding of the five components of an auditee's internal control to plan the audit of the entity's compliance with the laws, regulations, and provisions of contracts or grant agreements that could have a direct and material effect on the auditee's major federal programs.

This understanding of internal control components should be used to—

- Identify types of potential noncompliance applicable to major programs.
- Consider factors that affect the risk that material noncompliance applicable to major programs could occur.
- Design substantive tests applicable to compliance with major program requirements.

The level of understanding of each internal control component that the auditor should obtain varies according to—

- The complexity and sophistication of the auditee's operation, the systems used, and the environment in which it operates.
- The nature, complexity, and newness of the federal awards.

- Previous experience with the auditee and prior audit findings.
- The nature of the particular control and the auditee's documentation of specific controls.
- The assessment of inherent risk (that is, the susceptibility of transactions to material noncompliance).
- The auditor's judgment about materiality.
- The preliminary audit strategy.

Ordinarily, the auditor obtains an understanding of internal control components by a combination of the following:

- Previous experience with the entity
- Inquiry of auditee personnel and observation of auditee activities and operations
- Inspection of auditee-prepared documents and records

To begin audit procedures related to internal control over compliance, auditors must first determine the major programs that are subject to the A-133 audit and the compliance requirements that could have a direct and material effect on those programs. Chapter 4 of this practice guide discusses how to select major programs and identify the compliance requirements to be audited, and a Practice Aid (in the portion that accompanies this guide) illustrates those processes in a case study.

Understanding Internal Control and Assessing Control Risk

After determining the major programs and compliance requirements to be audited, auditors should perform procedures to understand internal control over compliance and to assess control risk. The AICPA Audit Guide *Consideration of the Internal Control in a Financial Statement Audit* (the Internal Control Audit Guide) provides procedures for understanding and assessing control risk related to financial reporting. However, auditors could consider using that guidance to help them understand and assess control risk related to compliance. Auditors also should consider consulting Part 6 of the *Compliance Supplement*, which describes, for each type of compliance requirement, the objectives of internal control and certain characteristics of internal control that when present and operating effectively may help to ensure compliance with program requirements.⁷ Evaluating an auditee's internal control over compliance with requirements that could have a direct and material effect on major programs in relation to those Compliance Supplement characteristics will help the auditor to assess the level of control risk.

SAS No. 55⁸ and the Internal Control Audit Guide discuss how control risk can be assessed at the maximum or below the maximum. That literature recognizes that control risk exists on a continuum from maximum to low—that control risk is not black-and-white. On the other hand, A-133 requires the auditor to understand the internal control, plan the testing of internal control to support a low assessed level of control risk for major programs, and perform the testing as planned; if this cannot be achieved, A-133 requires the auditor to report a reportable condition or material weakness as an audit finding. Although a low assessed level of control risk is not defined in the professional literature, in terms of A-133 it could be thought of as internal control that, in the auditor's judgment, will prevent or detect material noncompliance with requirements for a major program.

Assessing control risk related to compliance involves the following:

- Identifying specific controls relevant to compliance requirements that could have a direct and material effect over a major program

⁷ Auditors can use electronic versions of the *Compliance Supplement*, which are available from the sources indicated in the appendix to the Practice Aids portion of this practice guide, to develop questionnaires from Part 6 to assist them in obtaining an understanding of internal control over federal programs. Auditors may need to customize those questionnaires because of differences in the manner in which auditees consider and implement internal control. They also may need to update those questionnaires as new editions of the *Compliance Supplement* are issued.

⁸ See footnote 1.

- Performing tests of controls to evaluate the effectiveness of such controls
- Concluding on whether the controls are effective to support the assessed level of control risk

The auditor needs to exercise professional judgment to determine the procedures necessary to obtain a low level of control risk. In doing this, it may be helpful for the auditor to understand the purpose of the A-133 requirement to plan the tests of controls to achieve a low assessed level of control risk—federal agencies want the auditor to test controls over the compliance requirements for major programs so that they can be made aware of conditions that indicate that recipients have not implemented sufficient internal control over compliance with federal programs. In addition, auditors should consider the following guidance from chapter 4 of GAS as it relates to control risk assessment:

1. The lower the auditor's assessment of control risk, the more evidence the auditor needs to support that assessment.
2. Auditors may have to use a combination of different kinds of tests of controls to get sufficient evidence of a control's effectiveness.
3. Inquiries alone generally will not support an assessment that control risk is below the maximum.
4. 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.
5. 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 those tests were last performed.

Nature, Timing, and Extent of Internal Control Tests

Tests of internal control are directed toward the effectiveness of the design and operation of a control. The evidential matter that would be sufficient to support a low assessed level of control risk is a matter of professional judgment. The auditor's decisions about the nature, timing, and extent of tests of controls, and the interrelationship of evidential matter, affect the degree of assurance the evidential matter provides.

Tests of internal control over compliance could include the following procedures:

- Inquiries of appropriate personnel
- Inspection of documents and reports
- Observation of the application of specific controls
- Reperformance of the application of the controls

The nature of particular controls influences the type of evidential matter that is available to evaluate. For controls for which documentary evidence exists, the auditor may choose to examine the supporting documents. For controls for which documentary evidence may not exist, the auditor may choose to observe the control in operation. Certain controls (for example, segregation of duties) often may be tested only by inquiry and observation. (In this situation, the auditor should consider the GAS guidance that inquiries alone generally will not support an assessment that control risk is below the maximum.)

The timing of evidential matter concerns when it was obtained and the portion of the audit period to which it applies. Evidential matter about the effective design and operation of controls that was obtained in prior audits may be considered by the auditor in assessing control risk in the current audit provided that the controls continue to operate effectively during the current audit period. (That is, tests of controls from a prior audit can be used to help support a low assessed level of control risk and, thus, a smaller sample for purposes of testing internal control than if there were no such prior evidential matter.) However, the auditor should consider the effect of any changes in controls and personnel subsequent to the prior audit.

Auditors often perform tests of controls during interim work. When the auditor performs interim test work, he or she should determine what additional evidence needs to be obtained for the remaining portion of the period. The auditor also should consider that the longer the time elapsed since the evidential matter was obtained, the less assurance those tests may provide.

More extensive tests of controls usually provide increased evidential matter about the consistent application of a control and therefore may support a lower control risk assessment than what would be supported by less extensive tests.

When testing internal control, the auditor should consider multipurpose testing. For example, tests of controls performed in connection with the audit of the financial statements also may serve as tests of controls for major federal programs if the same system is used to process the transactions. In addition, dual tests of internal control and compliance could be performed on the same test sample.

SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), states that either nonstatistical or statistical approaches can be used to select audit samples. Both approaches require the use of professional judgment in planning, performing, and evaluating a sample and in relating the evidential matter produced by the sample to other evidential matter when forming a conclusion about the related audit objective. A-133 also does not express a preference for the approach used to select an appropriate audit sample.

For further information on audit sampling see SAS No. 39 and the AICPA Guide *Audit Sampling*. The Audit Guide discusses sampling in tests of internal controls and in substantive tests of details, as well as dual-purpose testing.

Exhibit 5-3, at the end of this chapter, summarizes the steps that an auditor may wish to use in testing controls.

EVALUATING THE RESULTS OF TESTS OF CONTROLS

In evaluating the results of tests of controls, the auditor may find that the controls do not support a low assessed level of control risk. As discussed in chapter 8 of SOP 98-3, in this situation, the auditor is not required to expand testing of internal control over compliance; he or she may choose to assess control risk at other than low, design tests of compliance accordingly, and consider the need to report an audit finding. In general, the auditor would report a reportable condition or material weakness. On the other hand, the auditor may decide to expand the testing of internal control over compliance if he or she believes that expanded internal control testing would be more efficient than additional tests of compliance. If expanded internal control testing can support an assessed level of control risk below the maximum, the amount of substantive tests of compliance can be reduced. If it cannot, the auditor should assess control risk at the maximum.

The auditor also may have special considerations in relation to federal program clusters. An auditee may have separate controls related to individual federal programs that are treated as a program cluster for the A-133 audit. In chapter 8 SOP 98-3 states that when evaluating whether an identified deficiency in internal control over a program that is part of a cluster is a reportable condition, the auditor should consider the significance of the deficiency in relation to the overall program cluster rather than the individual program. For example, significant deficiencies in specific controls over time cards of college work-study students would likely be considered a reportable condition if work-study program expenditures are significant in relation to the student financial aid (SFA) cluster. On the other hand, a deficiency in an SFA program that is insignificant to the SFA program cluster as a whole would not necessarily be considered a reportable condition.

As discussed further in chapter 7 of this practice guide, the auditor's determination of whether a deficiency in internal control over compliance 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*. A-133 also requires the auditor to identify reportable condition audit findings that are individually or cumulatively material weaknesses. For purposes of the report on internal control over compliance in accordance with A-133, the level of evaluating reportable conditions and material weaknesses in internal control over compliance is higher—it is at the major program level.

DOCUMENTING INTERNAL CONTROL WORK

The auditor's documentation of internal control work should reflect an understanding sufficient to plan the audit. For an auditee with simple internal control over federal programs, a memorandum may be adequate. Flowcharts and questionnaires often are used for documenting more complex internal controls.

The auditor may concurrently obtain and document his or her understanding of internal control. For example, if the auditor prepares flowcharts or completes a questionnaire, the flowcharts and completed questionnaire may be sufficient documentation. The auditor needs to document only the aspects of internal control that are relevant to the audit.

The auditor also should thoroughly document his or her work in assessing control risk and in testing internal control. The auditor should note that chapter 4 of GAS, requires the working papers to contain 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. (See also the discussion on documentation earlier in this chapter under "Internal Control Over Financial Reporting.")

If issues are identified that require reporting in accordance with the provisions of A-133, the auditor should consider identifying those issues in a separate section of the working papers to facilitate the later reporting process. Those issues may include not only the reportable conditions and material weaknesses identified because internal control over a compliance requirement is likely to be ineffective, but also reportable conditions and material weaknesses identified in the testing of internal control over compliance.

EXHIBIT 5-1 • FLOWCHART OF AUDITOR REQUIREMENTS RELATED TO INTERNAL CONTROL OVER COMPLIANCE WITH FEDERAL PROGRAM REQUIREMENTS

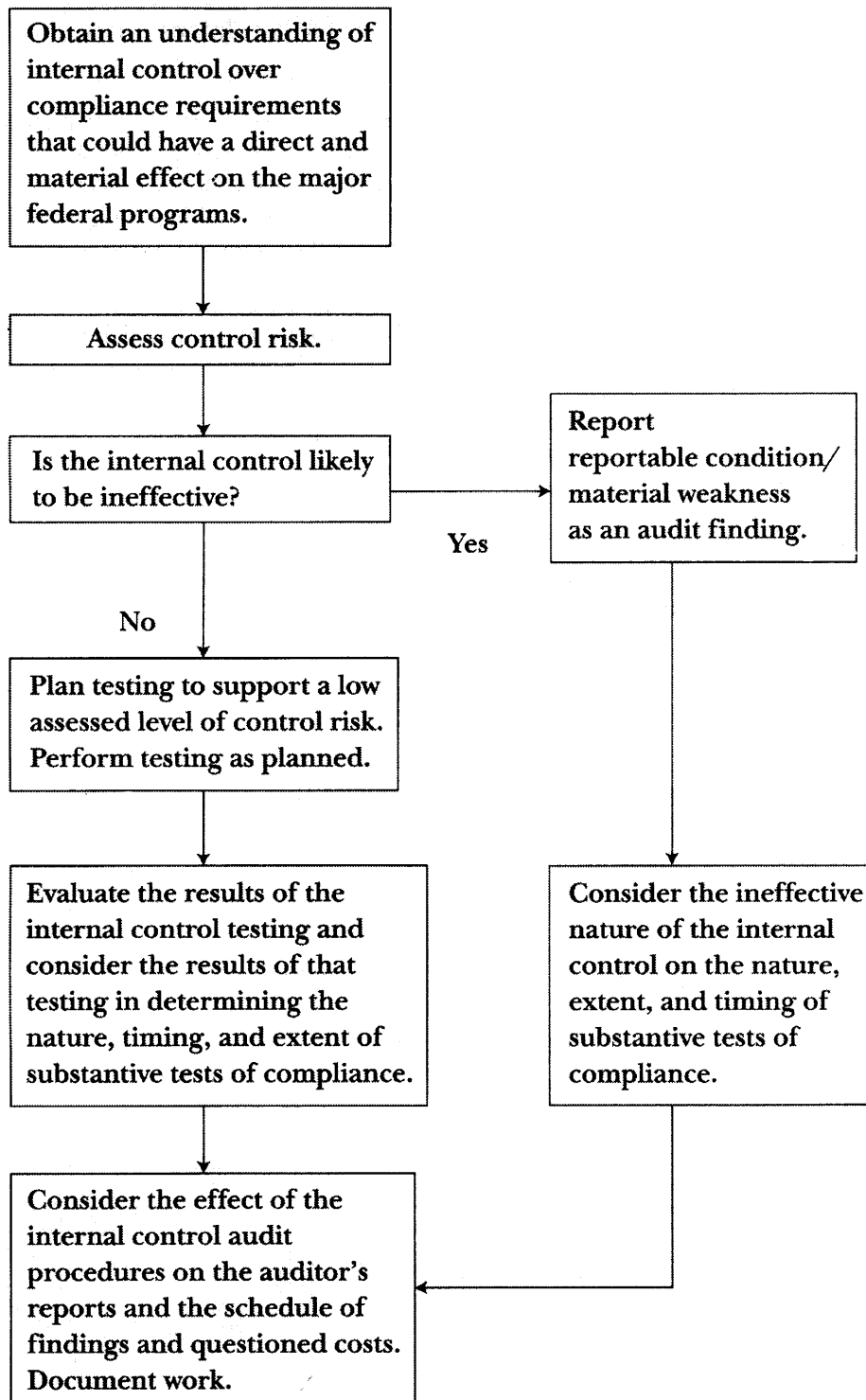


EXHIBIT 5-2 • INTERNAL CONTROL PROCEDURES AND REPORTS

	<i>Procedures</i>	<i>Reports</i>
GAAS	Obtain an understanding of internal control over financial reporting sufficient to plan the audit and assess control risk.	Issue oral or written communication when reportable conditions are noted.
GAS	Same responsibilities as generally accepted auditing standards (GAAS) except that <i>Government Auditing Standards</i> requires additional documentation when assessing control risk at maximum for controls significantly dependent upon computerized information. <i>Government Auditing Standards</i> also requires auditors to communicate information to certain parties during the planning stages of an audit regarding the nature and extent of planned testing and reporting on internal control over financial reporting. <i>Government Auditing Standards</i> also provides additional guidance on safeguarding of assets and control over compliance with laws and regulations.	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 identification of those reportable conditions that are individually or cumulatively considered to be material weaknesses.
A-133	For internal control over financial reporting, the same procedures as required by GAAS and GAS. Also obtain an understanding of internal control over compliance requirements for federal programs sufficient to plan the audit to support a low assessed level of control risk for each major program. Plan the testing of internal control over compliance at that level and perform the testing as planned, unless the internal control is likely to be ineffective. If the internal control is likely to be ineffective, the auditor is to report a reportable condition (including whether such a condition is a material weakness), assess the related control risk at the maximum, and consider whether additional compliance tests are required because of ineffective internal control.	Report on internal control over financial reporting as required by GAS. Also, requires a written report on internal control over compliance. No opinions on internal control are required.

EXHIBIT 5-3 • STEPS IN PERFORMING TESTS OF CONTROLS

Design the plan	Determine the objectives of the tests. Determine the population. Determine the method of selecting the sample. Determine the sample size.
Perform tests	Select the sample. Examine the sample.
Evaluate the test results	Reach conclusions on the results of the tests.
Document the work	Document in the working papers the plan, the tests performed, the results obtained, and the conclusions reached.

CHAPTER 6: Compliance and Other Single Audit Issues

In performing a single audit, an auditor considers and reports on the auditee's compliance with the laws, regulations, and provisions of contracts and grant agreements that could have a direct and material effect on the determination of financial statement amounts as required by generally accepted auditing standards (GAAS) and *Government Auditing Standards* (GAS) (*compliance related to financial reporting*). The auditor also considers and reports on the auditee's compliance with the laws, regulations, and provisions of contracts and grant agreements that could have a direct and material effect on each of its major federal programs as required by Office of Management and Budget (OMB) Circular A-133 (A-133) (*compliance related to federal programs*). This chapter discusses professional standards and A-133 requirements for considering and reporting on compliance related to financial reporting and federal programs as well as how to perform and evaluate tests of compliance related to federal programs.¹ It also discusses the auditor's responsibilities in relation to the schedule of expenditures of federal awards and prior audit findings. A case study illustrating the auditor's consideration of and reporting on an auditee's compliance related to federal programs is a Practice Aid to this practice guide.

COMPLIANCE RELATED TO FINANCIAL REPORTING

By their nature, governmental entities and not-for-profit organizations may be required to comply with the requirements of numerous laws, regulations, and provisions of contracts and grant agreements (*compliance requirements*). An entity's management is responsible for complying with those requirements by identifying the applicable requirements and establishing internal control that will provide reasonable assurance of compliance with them. GAAS and GAS establish various requirements and guidelines related to the auditor's consideration of compliance in a financial statement audit.

Statement on Auditing Standards (SAS) No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Requirements of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), provides general guidance when the auditor is engaged to audit an entity that receives federal awards under GAAS, GAS, and A-133. It describes the auditor's responsibility under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), as discussed below and for compliance auditing related to federal awards in an A-133 audit. SAS No. 74 effectively raises *Government Auditing Standards* and A-133 to the level of a SAS—meaning that failure to properly follow GAS and A-133 when engaged to do so would violate rule 202 of the AICPA Code of Professional Conduct.

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. (Chapter 4 of *Government Auditing Standards*, specifically extends this requirement to the provisions of contracts and grant agreements.) To do so, the auditor considers the following:

- Assessing whether management has identified compliance requirements that have a direct and material effect on the determination of financial statement amounts
- Obtaining an understanding of the possible effects of such compliance requirements on the determination of financial statement amounts

¹ See also the discussion of these issues in chapters 4 and 6 in Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.

- Assessing the risk that a material misstatement of the financial statements has resulted from noncompliance
- Designing and conducting the audit to provide reasonable assurance of detecting such material noncompliance

SAS No. 54 also requires that if specific information comes to the auditor's attention that provides evidence of the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. (Again, GAS specifically extends this requirement to the provisions of contracts and grant agreements.)

GAAS and GAS require the auditor to consider the effect of any noncompliance identified on the financial statements and the auditor's report thereon. GAS also requires a report on the financial statements that describes the scope of the auditor's testing of compliance with laws and regulations and the results of those tests. (It does not require auditors to express an opinion on compliance related to financial reporting. See chapter 5 of GAS for the criteria for reporting noncompliance.) Auditors also should evaluate whether instances of noncompliance identified during the audit provide an indication of an internal control weakness that should be reported. See the discussion of the auditor's report on compliance related to financial reporting in chapter 7 of this practice guide, and see exhibit 6-3, at the end of this chapter, for a flowchart that may assist auditors in making appropriate decisions on reporting instances of noncompliance related to financial reporting.

COMPLIANCE RELATED TO FEDERAL PROGRAMS

A-133 requires that the auditee comply with the laws, regulations, and provisions of contracts or grant agreements related to each of its federal programs. A-133 requires the auditor to determine whether the auditee has complied with the laws, regulations, and provisions of contracts or grant agreements that could have a direct and material effect on each of its major programs. The auditor's consideration of compliance related to federal programs is to include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance. This is because A-133 requires the auditor is to issue an opinion (or disclaimer of opinion) on the auditee's compliance related to federal programs.²

See the discussion of the auditor's report on compliance related to federal programs in chapter 7 of this practice guide.

PLANNING THE NATURE, EXTENT, AND TIMING OF TESTS RELATED TO COMPLIANCE

Before the auditor can perform tests of the auditee's compliance with requirements that could have a direct and material effect on each of its major programs, he or she identifies the major programs and the applicable compliance requirements and develops a preliminary audit strategy. The auditor also performs procedures on internal control related to compliance. Those processes are discussed in chapters 4 and 5 of this practice guide.

The auditor also develops at least a preliminary assessment of the level of control risk related to compliance before planning and performing compliance tests, be they substantive tests of transactions or other procedures.³ This is because the auditor uses his or her knowledge of internal control related to compliance

² A-133 also requires the auditor to perform follow-up procedures on previously identified findings. See the discussion at "Follow-up on Prior-Year Findings," later in this chapter.

³ Compliance testing can be performed concurrently with or after the tests of internal control.

and the assessed level of control risk to determine the nature, timing, and extent of compliance tests. A low assessed level of control risk would require less extensive testwork to support the opinion on compliance; a higher assessed level of control risk would require more extensive testwork. See the discussion concerning assessing internal control over compliance with federal programs in chapter 5 of this practice guide and chapter 8 of Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.

In planning the nature, timing, and extent of compliance tests, the auditor considers various issues, including materiality, the audit risk associated with the program, the amounts and types of transactions to test, issues related to testing indirect costs, and the nature of compliance testing procedures.

Materiality Considerations

In designing audit tests and developing an opinion on compliance related to federal programs, the auditor's consideration of materiality differs from that in an audit of financial statements. In an audit of financial statements, materiality is considered in relation to the financial statements being audited. When auditing compliance related to federal programs, however, materiality is considered in relation to each major program. Although the *Compliance Supplement* specifies particular types of compliance requirements for the auditor to test, the auditor applies the concept of materiality to each major program taken as a whole for purposes of the opinion on compliance.

However, A-133 also requires audit findings to be reported for material noncompliance with compliance requirements related to federal programs in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement*. Therefore, material noncompliance for purposes of reporting an audit finding is lower than material noncompliance for purposes of the opinion over compliance related to federal programs.

In assessing whether there is material noncompliance, the auditor considers not only individual instances of noncompliance but also the aggregation of those individual instances of noncompliance in relation to the program—for purposes of the opinion related to federal programs—and to the type of compliance requirement or audit objective—for purposes of an audit finding of material noncompliance.

Material noncompliance—whether for the purpose of the opinion or an audit finding—requires consideration of the nature and frequency of the noncompliance as well as the known and likely 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 another. Also, the auditor evaluates not only the identified instances of noncompliance, but also the likelihood that there are other, unidentified instances of noncompliance.

Noncompliance can be either quantitative (for example, noncompliance for which known and likely questioned costs can be measured) or qualitative. Determining whether instances of noncompliance that are qualitative (for example, a pass-through entity's failure to provide information about federal program compliance requirements to its subrecipients) are material requires professional judgment. Qualitative factors that indicate that an identified instance of noncompliance may not be material include (1) a low risk of public or political sensitivity, (2) a single exception with a low risk of being pervasive, or (3) the auditor's judgment and experience indicating that federal agencies or pass-through entities would normally not need to resolve the finding or take follow-up action or that the cost of recovery would exceed the amount of the finding.

A-133 also requires auditors to report as audit findings instances of noncompliance that result in the following:

- Known questioned costs⁴ greater than \$10,000 for a type of compliance requirement for a major program
- Known questioned costs when likely questioned costs⁵ are greater than \$10,000 for a type of compliance requirement for a major program
- Known questioned costs greater than \$10,000 for programs that are not audited as major programs

The need to determine whether instances of noncompliance are material for purposes of the opinion on compliance related to federal programs and reporting audit findings, as well as for reporting audit findings for likely questioned costs greater than \$10,000 for a type of compliance requirement for major programs, requires the auditor to project the error results identified in a test of sample transactions into the population. Statistical sampling methods include procedures for projecting the amount of error found in the sample to estimate the amount of error in the population. The auditor also can project the amount of error found in a nonstatistical sample to estimate the amount of error in the population by any one of several methods. The following describes two of the acceptable methods.⁶

One method of projecting the amount of misstatement found in a nonstatistical sample is to divide the amount of misstatement in the sample by the fraction of total dollars from the population included in the sample. For example, an auditor might have selected a sample that includes 10 percent of the recorded amount of the expenditures. If the auditor has found \$1,000 of misstatement in the sample, his or her best estimate of misstatement in the population could be calculated to be \$10,000 ($\$1,000 \div 10\%$). This method does not require an estimate of the number of sampling units in the population.

Under another method the auditor projects the average difference between the audited and the recorded amounts of each item included in the sample to all items constituting the population. For example, the auditor might have selected a nonstatistical sample of 100 items. If the auditor found \$200 of misstatement in the sample, the average difference between audited and recorded amounts for items in the sample is \$2 ($\$200 \div 100$). The auditor can then estimate the amount of misstatement in the population by multiplying the total number of items in the population (say 25,000 items) by the average difference of \$2 for each sample item. The auditor's estimate of error in the population is \$50,000 ($25,000 \text{ items} \times \2).

The two methods just described will give identical results if the sample includes the same proportion of items in the population as the proportion of the population's recorded amount included in the sample. If the proportions are different, the average amount of a sample item is generally different from the average amount of an item in the population. If the difference is significant, the auditor chooses between the approaches on the basis of his or her understanding of the magnitude and distribution of misstatements in the population. For example, if the auditor expects that the amount of misstatement relates closely to the size of an item, he or she ordinarily uses the first approach. On the other hand, if the auditor expects the misstatements to be relatively constant for all items in the population, he or she ordinarily uses the second approach.

If the auditor designed the sample by separating the items subject to sampling into groups, he or she should separately project the misstatement results of each group and then calculate his or her estimate of

⁴ *Known questioned costs* are questioned costs specifically identified by the auditor.

⁵ *Likely questioned costs* are the auditor's best estimate of total costs questioned, given the facts and circumstances, not just the known questioned costs. For example, the auditor specifically identifies noncompliance that results in \$6,000 of questioned costs. Given the size and nature of the sample examined as compared to the population, the auditor believes that the total questioned costs are in the range of \$40,000 to \$45,000. That range is the amount of likely questioned costs. Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, chapter 6, discusses how A-133 does not require the auditor to report an exact amount or 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. In reporting questioned costs, the auditor includes information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

⁶ The section that follows was taken from the AICPA Audit Guide *Audit Sampling*, Chapter 5, in the section "Evaluating Sample Results."

misstatement in the population by summing the individually projected amounts of error. The auditor also should add to the projected amount of misstatement any misstatement found in the individually significant items that were examined 100 percent.

Finally, the auditor considers the effect of noncompliance on the financial statements and the opinion on the financial statements. For this consideration, the auditor considers not only material noncompliance related to individual major programs but also the cumulative effect of all instances of noncompliance.

Audit findings and auditor's reports are discussed further in chapter 7 of this practice guide.

Audit Risk Associated With the Program

The auditor accumulates sufficient evidence to support the opinion on compliance related to federal programs. The auditor does this by limiting audit risk to an acceptably low level. Audit risk in relation to a financial statement audit is discussed in SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312). That discussion can be applied to an audit of compliance related to federal programs.

In the context of an audit of compliance related to federal programs, audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on compliance. Audit risk is made up of four elements: inherent risk, control risk, fraud risk, and detection risk. In relation to an audit of compliance related to federal programs, those elements can be defined as follows:

- Inherent risk is the susceptibility of the program to a material instance of noncompliance, assuming there is no related internal control.
- Control risk is the risk that material noncompliance could occur and not be prevented or detected on a timely basis by the auditee's internal control.
- Fraud risk is the risk that intentional material noncompliance with a major program's compliance requirements could occur.
- Detection risk is the risk that the auditor will not detect material noncompliance and thereby conclude that material noncompliance does not exist when it does.

The following discusses some factors the auditor should consider in identifying inherent, control, and fraud risks and in evaluating detection risk in auditing compliance related to federal programs.

The auditor's evaluation of inherent risk related to federal programs can be performed in part during the risk assessment of the programs for purposes of selecting major programs. (See the discussion in chapter 4 of this practice guide.) Some factors that can indicate higher inherent risk are the following:

- Complex compliance requirements
- New or newly revised program regulations
- A program that is in its start-up or close-out phase at the auditee
- Large amounts of contracting for goods or services
- Eligibility criteria, especially complex criteria
- Extensive contracting for goods or services
- Extensive use of subrecipients
- The use of extensive or complex computer processing in administering the program
- The identification of the program as higher risk in the *Compliance Supplement*

A-133 requires auditors to plan the audit to support a low assessed level of control risk for major programs. A-133 does not, however, require auditors to achieve that level of control risk. An assessment of control risk

(at whatever level it is assessed) combined with an assessment of inherent risk provides evidence about the extent to which material noncompliance may exist.

SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides guidance on planning and performing an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud. Chapter 6 of SOP 98-3, discusses how, even though SAS No. 82 does not apply to an audit of compliance related to federal programs, the auditor should specifically assess the risk of material noncompliance with major program compliance requirements occurring due to fraud and consider that assessment in designing audit procedures. The auditor could consult the AICPA Practice Aid *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS 82* to assist in this assessment.

Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. Detection risk also is a function of inherent, control, and fraud risks—the less the inherent, control, and fraud risk the auditor believes exists, the greater the detection risk he or she can accept. Accordingly, the auditor should consider the assessments of inherent, control, and fraud risks in concluding on the nature, timing, and extent of compliance tests.

Amounts and Types of Transactions to Test

The form and extent of documentation of management's compliance will vary because of various factors, such as the nature of the compliance requirements and the size and complexity of the entity. Documentation may be in the form of accounting and statistical data, case files, policy and procedures manuals, accounting manuals, narrative memorandums, flowcharts, and internal auditor's reports. To determine how to test the auditee's compliance, the auditor obtains an understanding of this compliance documentation—generally as part of his or her consideration of internal control over the compliance requirements.

SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), discusses the factors to be considered in planning, designing, and evaluating audit samples, whether for tests of internal control or for substantive tests. See also the AICPA Audit Guide, *Audit Sampling*, for guidance on audit sampling.

Although the auditor must obtain sufficient evidence to support an opinion on compliance for each major program, separate samples for each major program are not required. Experience has shown, however, that it is preferable to select separate samples for each major program, because separate samples clearly provide 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 (1) that a sample was selected from each major program and (2) that the results of tests of such samples, together with other audit evidence, are sufficient to support the required opinion on each major program.

In selecting a sample for testing compliance related to federal programs, the auditor also should consider the following issues:

- Sampling method: The auditor may use either statistical or nonstatistical sampling.
- The audit objectives of the tests: Suggested audit objectives for compliance testing are set forth in Parts 3, 4, and 5 of the *Compliance Supplement*.
- The population and sampling unit: The population consists of the total number of items constituting the account balance, class of transactions, or other transactions, documents, or events. The sampling unit is any of the individual items that make up the population. Exhibit 6-1, at the end of this chapter, illustrates the items that might make up the population for each of the fourteen compliance requirements discussed in the *Compliance Supplement*.

- **Completeness of the population:** The auditor not only considers the individual items reflected in the records or files but also performs tests to determine if the entire population is reflected. For example, before testing the auditee's records, the auditor may test transactions or award agreements to determine that they have been completely and appropriately recorded. That is, the auditor should consider not only vouching from records to documents but also tracing from documents to records.
- **Identified individual significant items:** Because the auditor is required to report known questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program, auditors use their judgment to determine if large dollar transactions should be individually tested. Any items so individually selected for testing would not be part of the population subject to sampling.
- **The sample size:** In determining the sample size, the auditor should consider:
 - Current and prior audit experience relative to compliance
 - Oversight exercised by federal agencies and pass-through entities
 - Inherent risk of the federal program
 - The adequacy of the internal control over federal programs
 - Audit procedures other than substantive testing that will be used to achieve the audit objectives

In selecting a test sample, the auditor also should consider the size of the individual transactions and their diversity. In performing tests of transactions, an auditor normally would select more items to reduce detection risk if the transactions are small in amount than if they are large. Concerning diversity, if a program has various types of material transactions—for example, personnel costs, supplies, contracted services, and subrecipient payments—the auditor could consider extending the sample to cover all expenditure areas. Further, the auditor could consider in his or her selection of test items both transactions that are routine or recurring and those that are nonrecurring or unusual.

The federal government has expressed certain expectations for sample sizes for tests of compliance with major programs. In September 1993, the President's Council on Integrity and Efficiency Standards Subcommittee issued a report, *Study on Improving the Single Audit Process*. On pages 54 and 55 of the report, the subcommittee said:

With a significant compliance requirement and populations of 200 or more, the auditor would normally be expected to test between 40 and 60 transactions for compliance. However, after a major program has been audited for several years, Controls Over Compliance have been found to be effective and previous audits have not found compliance deviations, the auditor might decide to reduce sample size.

For example, during the first audit of a program tested as major, the auditor might determine that controls over compliance are effective and decide to test 60 transactions for compliance. The result may be that there was no more than one deviation. If during the second year there were only minor changes in conditions and the tests indicated the controls were still effective, the auditor might decide to only test 40 transactions. The result again might be no more than one deviation. Then, in the third year, if conditions were the same and internal controls were considered effective, then the auditor may only test 25 transactions. [A footnote states: Generally, sample sizes of less than 25 transactions would not meet federal expectations unless the population sizes were very small.] Often the sample size for internal controls will also be tested for compliance and can be used to meet the expected sample size for compliance.

Indirect Costs

Part 3 of the *Compliance Supplement* draws the auditor's attention to special considerations that should be given to compliance testing of indirect costs. In the year that indirect or allocated costs could have a direct and material effect on any major program, the auditor is responsible for determining that the costs charged to cost pools that were used to calculate the indirect cost rate or that were allocated through the cost allocation plan

or indirect cost rate agreement were proper. Because it may not be practical to perform such tests retroactively (for example, when there is a change in auditors), the Office of Management and Budget (OMB) encourages the auditor to perform tests of costs charged to cost pools during the period the actual costs are incurred or during the period when the proposal or plan is finalized, rather than waiting until the period when the rate is applied or in which the costs are allocated.

To illustrate the unique timing considerations relating to indirect costs and the effect on the audit process, assume that the actual costs charged to cost pools for 2007 form the basis for the indirect cost proposal to be submitted in 2008 and the final negotiated indirect cost rate that will be applied in 2009. Also, assume that indirect costs charged to a major program in 2009 are material. In this situation, the OMB strongly encourages the auditor to test actual costs charged to cost pools during 2007 as part of the 2007 or 2008 audit. If the auditor tests the actual costs charged to the cost pools as part of either the 2007 or 2008 audit (or can appropriately rely on the work performed by other auditors in those years), the auditor's responsibility in 2009 will relate primarily to determining whether the appropriate rate was applied in 2009. However, if no prior audit work was done relating to the actual costs charged to cost pools used to support the rate used to charge a major program in 2009, the auditor conducting the 2009 audit would be expected to test such costs, in addition to determining whether the appropriate rate was applied in 2009.

The Nature of Compliance Testing Procedures

The auditor applies professional judgment in selecting and applying procedures that will provide sufficient evidence for the opinion on compliance related to federal programs. SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), indicates that the following presumptions may be useful in obtaining valid evidential matter:

- Evidence obtained from independent sources outside an entity generally provides greater assurance of reliability than that secured solely within the entity.
- The more effective the internal control, the more assurance it provides about the reliability of the information.
- The auditor's direct personal knowledge, obtained through physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.

Compliance tests may be performed concurrently with or separately from tests of internal control over the compliance requirements. Normally, compliance tests involve the examination of evidence that supports transactional details, such as expenditures records and invoices, files documenting eligible beneficiaries, contracts with subrecipients and contractors, and federal financial reports. However, A-133 provides that the auditor's consideration of compliance related to federal programs is to include tests of transactions and *such other auditing procedures* as are necessary to provide the auditor sufficient evidence to support an opinion on compliance. Therefore, the auditor may determine that other procedures—such as analytical procedures—assist in providing sufficient evidence to support the opinion. For example, in auditing the allowable costs compliance requirements for a major program, the auditor may combine detailed tests of transactions with an analytical review of actual costs compared to budgeted amounts. Another procedure could include reviewing reports of significant examinations and related communications between the auditee and federal agency or pass-through entity.

USE OF THE COMPLIANCE SUPPLEMENT

Parts 3, 4, and 5 of the *Compliance Supplement* are designed to assist auditors in planning and performing tests of compliance related to federal programs. Besides describing the fourteen types of compliance requirements, those parts also describe related audit objectives and suggest audit procedures. Auditors can use electronic versions of the *Compliance Supplement*, which are available from the sources indicated in the

appendix to the Practice Aids of this practice guide, to develop audit programs for testing compliance related to federal programs. Auditor judgment is needed, however, to determine whether the audit procedures suggested in the *Compliance Supplement* are sufficient to achieve the stated audit objectives and whether additional or alternative audit procedures are needed. The use of the *Compliance Supplement* to identify audit objectives and procedures is illustrated in a case study presented as a Practice Aid to this practice guide.

SUBSEQUENT EVENTS

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 provided in SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 560, "Subsequent Events"). The auditor considers information about such events that comes to his or her attention after the end of the period relating to the applicable compliance requirements and before the issuance of his or her report.

Two types of subsequent events require consideration by management and evaluation by the auditor. The first type is events that provide additional information about the entity's compliance during the reporting period. For the period from the end of the reporting period to the date of the auditor's report (the subsequent period), the auditor performs procedures to identify such events that provide additional information about compliance during the reporting period. Such procedures include, but may not be limited to, inquiring about and considering:

- Relevant internal auditors' reports issued during the subsequent period.
- Other auditors' reports identifying noncompliance issued during the subsequent period.
- Regulatory agencies' reports on the entity's noncompliance issued during the subsequent period.
- Information about the entity's noncompliance obtained through other professional engagements for that entity.

The second type of subsequent event consists of noncompliance that occurs subsequent to the period but before the date of the auditor's report. The auditor has no responsibility to detect such noncompliance. However, should the auditor become aware of such noncompliance, it may be of such a nature and significance that it should be disclosed in the notes to the schedule of expenditures of federal award to keep the auditor's report on compliance related to federal awards from being misleading. If such disclosure is not made, an explanatory paragraph would be included in the auditor's report describing the nature of the noncompliance.

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

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. Professional standards related to this type of report are presented in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551).

As discussed in chapter 5 of this practice guide, the auditor will have performed certain procedures on the schedule of expenditures of federal awards in selecting major programs for the single audit. The auditor also should consider the following procedures in reaching an opinion on the schedule of expenditures of federal awards:

- Determine whether the schedule includes all federal awards expended during the period.
- Determine that the schedule or the notes thereto report the auditee's noncash federal awards.

- Determine whether the federal expenditures reported in the schedule (or the notes thereto) are recognized and measured in accordance with the requirements of A-133 and the basis of accounting disclosed in the notes to the schedule. (See exhibit 6-2, at the end of this chapter, for the basis for determining the amounts that should be reported as federal expenditures for noncash awards.)
- Determine that the schedule and the notes thereto contain the minimum information required by A-133.
- Evaluate the completeness and classification of the auditee's recorded federal revenues and expenditures.
- Compare the information in the schedule with the audited financial statements and other knowledge obtained during the audit of the financial statements.
- Compare the information in the schedule and the notes thereto with the audited financial statements and with the federal financial reports.

A Practice Aid to this practice guide is a checklist of illustrative audit procedures related to the schedule of expenditures of federal awards. Chapter 7 of this practice guide discusses the reporting requirements for the schedule of expenditures of federal awards.

FOLLOW-UP ON PRIOR AUDIT FINDINGS

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 a current year audit finding if the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. Therefore, the auditor should perform audit follow-up procedures regardless of whether a prior audit finding relates to a current-year major program. (The auditor may wish to consider performing the procedures set forth in a Practice Aid to this practice guide to assess the reasonableness of the auditee's summary schedule of prior audit findings.) However, if the auditee is not required to have an A-133 audit in the current year, the auditor is not required to follow-up on prior year audit findings related to federal awards.

Chapter 7 of this practice guide discusses the reporting requirements for the summary schedule of prior audit findings.

MANAGEMENT REPRESENTATIONS

In performing an A-133 audit, GAAS requires the auditor to obtain written representations from the auditee's management about matters related to federal awards, including the completeness of the schedule of expenditures of federal awards, the establishment and maintenance of internal control over compliance with federal programs, compliance related to federal programs, and identification of known instances of noncompliance (see also SOP 98-3, chapter 6). SOP 98-3, chapter 6, based on SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), provides that management's refusal to furnish appropriate written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion on the auditee's compliance with major program requirements. Further, the auditor should consider the effects of the refusal on his or her ability to rely on other management representations. The auditor also should consider making inquiries of the auditee's attorneys about matters related to A-133, for example, if a federal agency is investigating or suing the auditee.

A checklist for management representations and an illustrative management representation letter are presented as Practice Aids to this practice guide.

EVALUATING THE RESULTS OF TESTS OF COMPLIANCE

The auditor's tests of compliance with compliance requirements may disclose instances of noncompliance. As discussed earlier in this chapter in the section "Materiality Considerations," noncompliance is evaluated for materiality for reporting purposes at three levels: (1) audit findings of material noncompliance in relation to a type of compliance requirement or audit objective related to a major program, (2) the opinion on compliance related to each major program, and (3) the opinion on the financial statements. In addition, instances of noncompliance that result in certain amounts of known or known and likely questioned costs also are reported as audit findings. Therefore, the auditor evaluates different aggregations of identified instances of noncompliance. Further, the auditor considers the effect of noncompliance on the financial statements and the opinion on the financial statements. Auditors also should evaluate whether instances of noncompliance identified during the audit provide an indication of an internal control weakness that should be reported.

Exhibit 6-4, at the end of this chapter, is a flowchart that may assist auditors in making appropriate decisions on reporting instances of noncompliance related to federal programs. See the further discussion of compliance reporting in chapter 7 of this practice guide and chapters 6 and 10 of SOP 98-3.

DOCUMENTATION

Auditors should document in the working papers their planning and testing of compliance related to federal programs as well as their evaluation of the results of the tests and their conclusions. *Government Auditing Standards*, chapter 4, requires the working papers to contain 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. (See the discussion on the internal control documentation required by GAS in chapter 5 of this practice guide.) Further, auditors should document in the working papers the procedures applied to the schedule of expenditures of federal awards and the summary schedule of prior audit findings and the conclusions.

EXHIBIT 6-1 • POPULATION UNITS FOR TESTING COMPLIANCE REQUIREMENTS

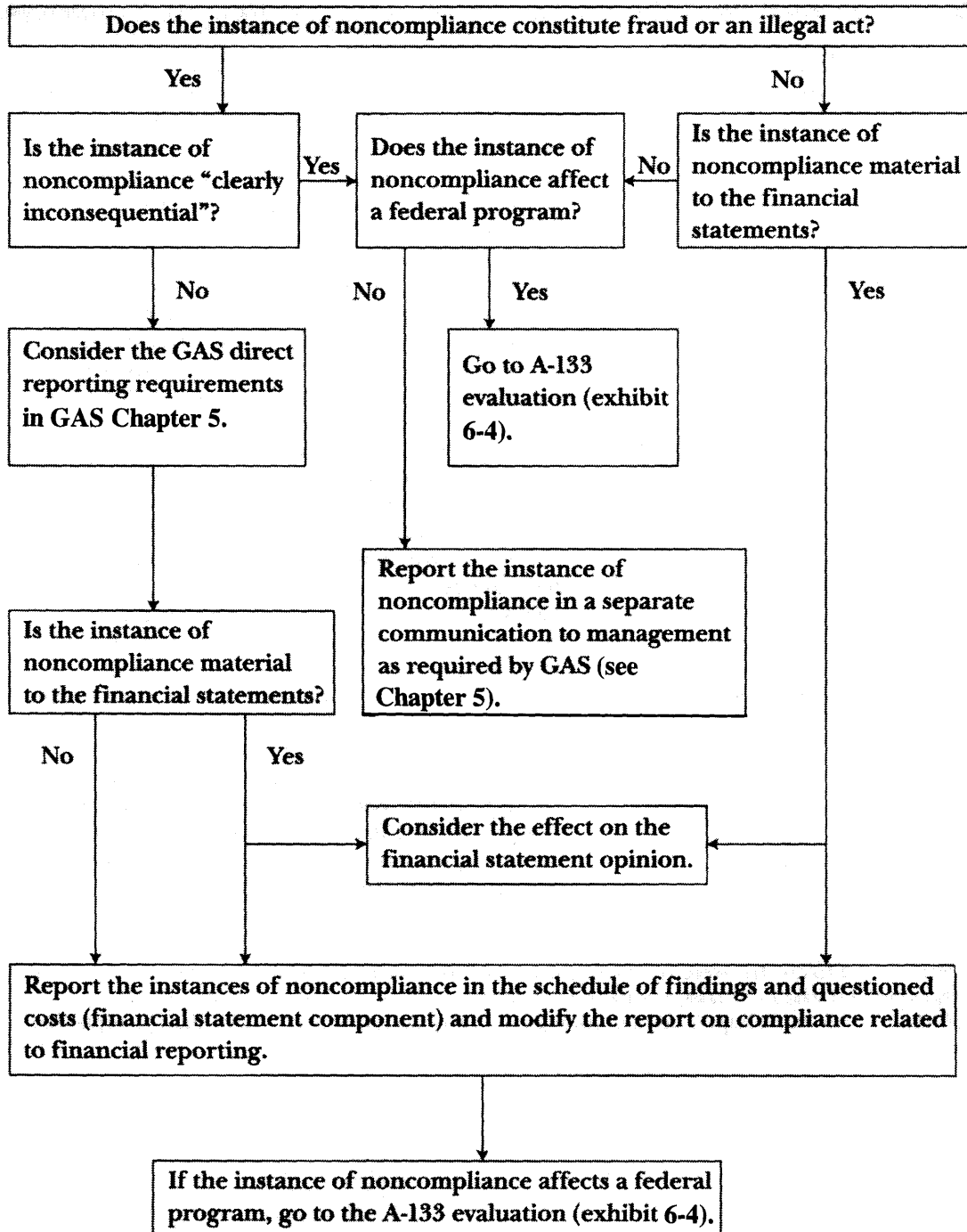
<i>Requirements</i>	<i>Population</i>
A. Allowable activities	Award and agreements; transactions
B. Allowable costs	Transactions
C. Cash management	Transactions
D. Davis-Bacon Act	Contracts; transactions
E. Eligibility	Beneficiaries/awards; transactions
F. Equipment and real property management	Transactions
G. Matching, level of effort, earmarking	Transactions
H. Period of availability of federal funds	Transactions
I. Procurement and suspension and debarment	Purchase orders and contracts
J. Program income	Transactions
K. Real property acquisition and relocation assistance	Purchase orders, contracts, and awards
L. Reporting	Reports
M. Subrecipient monitoring	Award agreements; transactions
N. Special tests and provisions	Various

EXHIBIT 6-2 • BASIS FOR DETERMINING NONCASH FEDERAL EXPENDITURES

<i>Types of Noncash Awards</i>	<i>Basis Used to Determine Amounts to Be Reported as Federal Expenditures</i>
Loans and loan guarantees (loans)*	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 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 institutions of higher education does not make the loans, only the value of loans made during the year is considered federal awards expended. The balance of loans for previous years is not included because the lender accounts for 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.

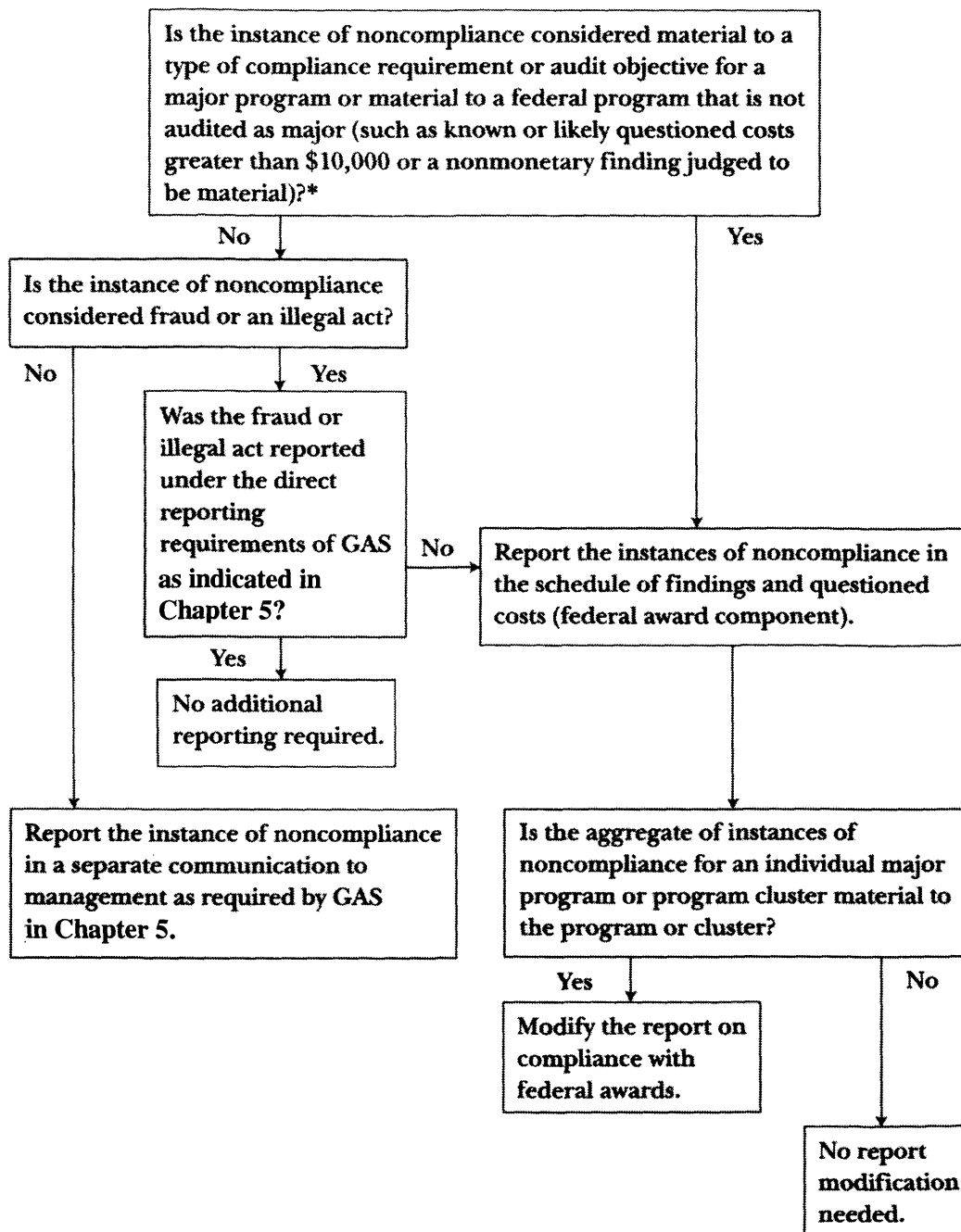
*The proceeds of loans that were received and expended in prior years are not considered federal awards expended when the laws, regulations, and provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

EXHIBIT 6-3 • EVALUATION OF NONCOMPLIANCE RELATED TO FINANCIAL REPORTING



Note: Compliance findings also should be evaluated to determine if they provide an indication of an internal control weakness.

EXHIBIT 6-4 • EVALUATION OF NONCOMPLIANCE RELATED TO FEDERAL PROGRAMS



Note: Compliance findings also should be evaluated to determine if they provide an indication of an internal control weakness.

* Individual instances of noncompliance that relate to the same federal program should be aggregated for the purpose of this evaluation.

CHAPTER 7: Reporting

This chapter discusses the content requirements of the single audit reporting package and the data collection form.¹(For program-specific audit reports, see chapter 8.) This chapter also discusses how to evaluate the results of audit testwork in developing the auditor's reports on internal control and compliance and audit findings. This practice guide includes a case study that illustrates reporting issues as a Practice Aid and a checklist for audit reporting as a Practice Aid. Additional guidance relating to other reports and communications in a single audit (such as required communications to management by generally accepted auditing standards (GAAS) and *Government Auditing Standards* (GAS)) is in chapter 10 of Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.

THE SINGLE AUDIT REPORTING PACKAGE

The single audit reporting package is to include the—

1. Financial statements.
2. Schedule of expenditures of federal awards.
3. Summary schedule of prior audit findings.
4. Corrective action plan.
5. Auditor's reports, including a schedule of findings and questioned costs.

Office of Management and Budget (OMB) Circular A-133 does not prescribe a sequence for including these items in the reporting package.

FINANCIAL STATEMENTS

The auditee is responsible for preparing the financial statements to be audited. The financial statements should include SOPs, results of operations or changes in net assets, and, if applicable, cash flows. The statements are not required to be prepared on a generally accepted accounting principles (GAAP) basis. The financial statements should be for the same organizational unit and period covered by the single audit. However, the financial statements may include departments, agencies, and other units that have separate single audits provided those units prepare separate financial statements. (See a further discussion concerning a series of audits in chapter 4 of this practice guide.)

Guidance on preparing GAAP financial statements for state and local governments, not-for-profit organizations, and health care organizations is presented in various Governmental Accounting Standards Board (GASB) and Financial Accounting Standards Board (FASB) pronouncements and in AICPA Audit and Accounting Guides.

¹ The Federal Audit Clearinghouse (FAC) collects information about Circular A-133 audits on a data collection form for entry into a database that it maintains on its Web site. This chapter refers to the data collection form to report the results of Circular A-133 audits for audit periods ending before January 1, 2001. In 2001, the OMB issued a *revised* data collection form and accompanying instructions to report the results of Circular A-133 audits for audit periods ending *on or after* January 1, 2001. For information related to both data collection forms, go to the FAC Web site, <http://harvester.census.gov/sac>.

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

The auditee also is responsible for preparing the schedule of expenditures of federal awards. A checklist of information that is to be included in the schedule is presented as a Practice Aid to this guide. A schedule of expenditures of federal awards is illustrated in a case study Practice Aid of this practice guide and in SOP 98-3.

The minimum required contents of the schedule of expenditures of federal awards are—

1. Individual federal programs by federal agency. A cluster of programs should be listed by individual program. For research and development (R&D), the display should be by individual award or by federal agency and major subdivision within the agency.
2. For pass-through awards, the pass-through entity and its identifying number.
3. For each program, total awards expended and the Catalogue of Federal Domestic Assistance (CFDA) or other identifying number.²
4. Notes describing the significant accounting policies used in the schedule

The notes to the schedule or, preferably, the schedule should include the value of noncash assistance expended, the amount of insurance in effect during the year, and the loans and loan guarantees outstanding at year end. To the extent practical, the schedule should identify the amounts of each program that were passed through to subrecipients. Also, the auditee may include additional information in the schedule at the request of federal awarding agencies and pass-through entities, although Office of Management and Budget (OMB) Circular A-133 (A-133) does not obligate the auditee to honor such requests.

An auditee's schedule of expenditures of federal awards need not include awards expended by departments, agencies, and component units that prepare separate financial statements and have separate single audits except to show any pass-through awards to those units. However, the auditor should consider the audit results of those units to the extent that any findings and questioned costs have a material effect on the auditee's financial statements.

The auditee is not required to include a reconciliation of the amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards in the notes to the schedule. However, as discussed in the preamble to A-133 (in response to comments on "Basis of Accounting"), the auditee must be able to reconcile the two amounts.

The information included in the schedule of expenditures of federal awards may not fully agree with the auditee's federal program financial reports because, among other reasons, the reports (1) may be for a different fiscal period and (2) may include cumulative (from prior years) data rather than only data for the current-year.

The auditee may decide to include non-federal awards—such as state awards—in the schedule. A-133 does not prohibit such a presentation. However, if that presentation is made, the schedule should segregate and clearly designate non-federal awards. The title of the schedule should be changed to indicate that non-federal awards are included. In addition, the auditor should consider the need to modify the auditor's reports and issue a separate schedule of non-federal findings and questioned costs, depending on the audit coverage and reporting requirements for those non-federal awards.

²A-133 requires CFDA numbers and titles to be included in the grant award documentation. If this information is not properly documented, the information should be obtained from the federal funding agency or pass-through entity.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee is required to prepare a summary schedule of prior audit findings. The schedule should include the finding reference numbers assigned by the auditor. Because the schedule may include audit findings from multiple years, it is to indicate the fiscal year in which the finding initially occurred.

The summary schedule of prior audit findings should include all findings reported in the prior audit's schedule of findings and questioned costs related to federal awards. (That is, A-133 does not require the schedule to include prior audit findings related to the financial statements. See the later discussion in this chapter concerning follow-up on prior audit findings related to the financial statements.) The schedule also should include the findings in the prior audit's schedule of prior audit findings except those that were listed as fully corrected, no longer valid, or no longer warranting further action. The status of prior findings could be one of the following:

<u>STATUS</u>	<u>STATEMENT IN SCHEDULE</u>
1. Fully corrected	1. State that corrective action was taken.
2. Not corrected or partially corrected	2. Indicate the planned corrective action and partial action taken.
3. Significantly different corrective action than previously planned	3. Explain the situation.
4. Finding no longer valid or does not warrant further action	4. Explain the situation.

A finding does not warrant further action if all of the following have occurred: (1) two years have passed since the finding was reported, (2) the federal agency or pass-through entity is not following up on the finding, and (3) a management decision was not issued.

Exhibit 7-1, at the end of this chapter, presents an illustrative summary schedule of prior audit findings.

CORRECTIVE ACTION PLAN

The auditee is required to prepare a corrective action plan to address the findings included in the current year schedule of findings and questioned costs. The corrective action plan is *required* to address each current-year finding related to federal awards (findings not related to federal awards may be included in the corrective action plan, but such findings are not required) and provide the finding reference number, the contact person(s) responsible for corrective action, the corrective action planned, and the anticipated completion date. The plan also should explain any auditee disagreements with the audit findings.

For findings related to the financial statements, GAS, chapter 7, requires the auditor's report to include views of responsible auditee officials concerning the auditor's findings, conclusions, and recommendations as well as the corrections planned. Rather than providing repetitive information about corrections planned in both a management response section of the finding and the corrective action plan, auditors and auditees should consider expanding the information provided in the corrective action plan to include the GAS-required views of responsible auditee officials.

Exhibit 7-2, at the end of this chapter, presents an illustrative corrective action plan.

AUDITOR'S REPORTS

A-133 requires the auditor's reports to state, as appropriate, that the audit was conducted in accordance with GAAS, GAS, and A-133 and include—

- An opinion (or disclaimer of opinion) about whether the financial statements are presented fairly in all material respects in conformity with GAAP and an opinion (or disclaimer of opinion) about 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.
- Reporting on internal control related to the financial statements and major programs. This report should describe the scope of testing of internal control and the results of the tests and, where applicable, should refer to the separate schedule of findings and questioned costs.
- Reporting on compliance with laws, regulations, and the provisions of contracts and grant agreements, with which noncompliance could have a material effect on the financial statements. This report also should include an opinion (or disclaimer of opinion) about whether the auditee complied with laws, regulations, and the provisions of contracts and grant agreements that could have a direct and material effect on each major program and, where applicable, should refer to the separate schedule of findings and questioned costs.
- A schedule of findings and questioned costs.

A-133 provides that the auditor's reports may be either combined or separate reports and may be organized differently from the manner presented in A-133. Chapter 10 of SOP 98-3 recommends the issuance of three reports:

1. An opinion on the financial statements and supplementary schedule of expenditures of federal awards
2. A report on compliance and on internal control over financial reporting based on an audit of the financial statements performed in accordance with GAS
3. A report on compliance with requirements applicable to each major program and internal control over compliance in accordance with A-133

SOP 98-3, appendix D, includes examples of these independent auditor's reports, some of which are included as Practice Aids to this practice guide.

All evaluations and conclusions related to the reporting process should be documented in the audit working papers.³

Opinion on the Financial Statements and Supplementary Schedule of Expenditures of Federal Awards

The requirements for this opinion are contained in GAAS and GAS. GAAS requirements are contained in Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). The auditor's standard report identifies the financial statements in an introductory paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinions on the financial statements and supplementary schedule of expenditures of federal awards in separate opinion paragraphs. The basic elements of this report, as taken from chapter 10 of SOP 98-3, are part of the reporting checklist Practice Aid to this practice guide.

³To assist the audit partner in reviewing the audit process from engagement letter through report distribution, an engagement review checklist is presented as a Practice Aid to this practice guide.

In arriving at the opinion on the financial statements, the auditor should consider the cumulative effect of all instances of noncompliance identified in the audit and the effect of restrictions on the scope of work on compliance. Also, the auditor should modify the scope paragraph of the report on the financial statements if a material component unit or fund was not audited in accordance with GAS; see chapter 10 of SOP 98-3.

SOP 98-3 recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, this reporting may instead be combined with the report on compliance with requirements applicable to each major program and internal control over compliance in accordance with A-133, for example, if the entity does not present the schedule of expenditures of federal awards in the same report as the financial statements. (See the further discussion in chapter 10 of SOP 98-3.)

Reporting on Compliance and on Internal Control Over Financial Reporting Based on an Audit of the Financial Statements Performed in Accordance With GAS

SOP 98-3 recommends that the A-133-required reports on compliance and internal control related to the financial statements be combined into a single report. The basic elements of this report, which are derived from GAS requirements, are part of the reporting checklist Practice Aid.

If part of the reporting entity is not audited in accordance with GAS, the scope paragraph of the report on compliance and internal control related to the financial statements should be modified as discussed in chapter 10 of SOP 98-3.

Report on Compliance With Requirements Applicable to Each Major Program and Internal Control Over Compliance in Accordance With A-133

SOP 98-3 also recommends combining into a single report the A-133-required reports on compliance with requirements applicable to each major program and on internal control over compliance. The basic elements of this report are listed in the reporting checklist Practice Aid. The report on compliance with requirements applicable to major programs expresses the auditor's opinion on whether the auditee complied with the compliance requirement that, if noncompliance occurred, could have a direct and material effect on a major program.

When the audit identifies material instances of noncompliance with the requirements applicable to a major program, the auditor should express a qualified or adverse opinion on compliance. (That evaluation is made in relation to the program as a whole, not in relation to a type of compliance requirement or audit objective listed in the *Compliance Supplement*, as required for audit findings.) The auditor should state the basis for his or her opinion in the report.

Restrictions on the scope of the auditor's work on compliance may require the auditor to express a qualified opinion or a disclaimer of opinion. For example, such circumstances as inadequate records may preclude the auditor from applying all of the procedures that he or she considers necessary in the circumstances. The decision to qualify or disclaim an opinion because of a scope limitation depends on the auditor's assessment of the nature and significance of the compliance requirement to the federal program and the importance of the omitted procedures on the auditor's ability to form an opinion on compliance over that program.

Additional guidance for modifying the opinion on compliance is presented in chapter 10 of SOP 98-3.

A-133 requires that the report on internal control over compliance refer to a description of reportable conditions in internal control over compliance that are reported in the schedule of findings and questioned costs, including an identification of those reportable conditions that are individually or cumulatively material weaknesses. For the purpose of this report, reportable conditions and material weaknesses are defined at the major program level. Therefore, although instances of noncompliance may have been identified as reportable conditions or material weaknesses at the level of the type of compliance requirement or audit objective for the

purpose of reporting audit findings, a higher level applies to the reference from the report on internal control over compliance. Therefore, auditors will need to evaluate whether the reportable conditions and material weaknesses identified as audit findings for a major program accumulate to result in a reportable condition or material weakness at the program level.

Schedule of Findings and Questioned Costs

The schedule of findings and questioned costs is prepared by the auditor and includes three major components.

1. A summary of auditor's results
2. Findings related to the financial statements that are required to be reported by GAS
3. Findings and questioned costs for federal awards

Audit findings that relate to the same issue should be presented as a single audit finding. Also, where practical, 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 places; such findings should be presented in detail in one place and in summary form in the other, with a cross-reference to the detailed presentation. Because the summary of auditor's results is required for each A-133 audit, the schedule of findings and questioned costs is required even if there are no current-year findings. If there are no current-year findings, the sections of the schedule of findings and questioned costs for GAS and federal award findings should indicate that no matters were reportable.

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. A separate letter (that is, a 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. Because all reportable findings are included in the schedule, there is no requirement for the auditor to refer to the management letter in the report on compliance with requirements applicable to each major program and on internal control over compliance.

The illustrative schedule of findings and questioned costs from appendix E of SOP 98-3 is presented as exhibit 7-3, at the end of this chapter. In addition, an illustrative schedule of findings and questioned costs is included in a case study Practice Aid to this practice guide.

Summary of Auditor's Results

The summary of auditor's results should include the following:

1. The type of report issued on the auditee's financial statements (that is, unqualified, qualified, and so forth)
2. Whether the audit disclosed reportable conditions and material weaknesses in internal control at the financial statement level
3. Whether the audit disclosed any noncompliance that is material to the financial statements
4. Whether the audit disclosed reportable conditions and material weaknesses in internal control over major programs. (For this purpose, reportable conditions and material weaknesses are defined at the major program level, not the type of compliance requirement or audit objective level.)
5. The type of report the auditor issued on compliance related to major programs (If the audit report for one or more major programs is other than unqualified, the summary should indicate the type of report issued for each program.)
6. A statement about whether the audit disclosed any audit findings related to federal awards
7. An identification of major programs using the CFDA or other identifying number and program name as listed in the schedule of expenditures of federal awards (For clusters of programs, the name of the cluster, rather than the name of the individual programs within the cluster, should be given.)

8. The dollar threshold used to distinguish between Type A and Type B programs
9. A statement whether the auditee qualified as low risk

Findings Related to the Financial Statements

Findings related to the financial statements are based on GAS. *Government Auditing Standards*, chapter 5, requires auditors to describe the scope of their testing of compliance with laws and regulations and present the results of those tests, including information on irregularities, illegal acts, other material noncompliance, as well as reportable conditions in internal controls over financial reporting. It also provides examples of situations that may be reportable conditions in internal controls, for example, evidence of failure to perform internal control tasks, such as not preparing reconciliations. (See also the Practice Aid to this practice guide for a checklist of possible reportable conditions in internal control over financial reporting.) GAS requires auditors to identify those reportable conditions that are individually or cumulatively material weaknesses.

Chapters 5 and 7 of *Government Auditing Standards* indicate that well-developed findings—those that provide sufficient information to federal, state, and local officials to permit timely and proper corrective action—generally consist of statements of—

- Condition (what is).
- Criteria (what should be).
- Effect (a measure of the difference between what is and what should be).
- Cause (why it happened).

However, the auditor may not be able to fully develop all of these points, given the scope and purpose of the audit.

GAS also discusses how, in reporting material fraud, illegal acts, and other noncompliance, auditors should put the finding in context. This is done by giving the reader a basis for judging the prevalence and consequences of the condition, for example, by relating the instances identified to the universe or the number of cases examined and quantifying those instances in terms of dollar value, if appropriate.⁴

Further, GAS requires that auditors report:

- Recommendations for actions to correct problem areas and to improve operations
- Views of responsible officials concerning auditors' findings, conclusions, and recommendations, as well as corrections planned (See the previous discussion concerning the reporting of the views of responsible officials in the section "Corrective Action Plan.")

A-133 also requires the auditor to assign a reference number to all findings, including those related to the financial statements, to allow for easy referencing of the audit findings during follow-up. A possible format for reference numbers would be the last two digits of the fiscal year followed by a numerical sequence of numbers. For example, findings identified and reported in the fiscal year 2000 audit would be numbered 00-1, 00-2, and so forth.

When auditors detect noncompliance or internal control weaknesses that are not required by GAS to be reported as audit findings, they should communicate those findings to the auditee, preferably in writing. If those findings have been communicated in a management letter, the auditor should refer to that letter in the report on compliance and internal control over financial reporting.

⁴ Chapter 5 of *Government Auditing Standards* indicates that less extensive disclosure is required for fraud and illegal acts that are not material in either a qualitative or quantitative sense and that auditors need not report fraud and illegal acts that are clearly inconsequential.

Government Auditing Standards, chapter 4, requires the auditor to report the status of uncorrected material findings and recommendations from prior audits that affect the current-year financial statement audit.⁵ That status could be reported in (1) the financial-statement-related section of the schedule of findings and questioned costs or (2) a separate schedule or summary. Because GAS requires that the auditor report the status of prior-year financial-statement-level findings, it is recommended that that reporting not be done in the A-133-required summary schedule of prior year findings, which is an auditee-prepared document. Frequently, the presentation of the status of these findings is done in a side-by-side summarization. The use of a table may be appropriate to summarize extensive findings.

Findings and Questioned Costs for Federal Awards

The types of findings related to federal awards that auditors should report are—

- Reportable conditions in internal control over major programs
- Material noncompliance with the laws, regulations, and provisions of contracts and grant agreements related to major programs
- Known questioned costs greater than \$10,000 (and, for major programs, known questioned costs when likely questioned costs are greater than \$10,000)
- Other types of findings

All audit findings required to be reported under A-133 must be included in the schedule of findings and questioned costs. A separate letter, such as a management letter, may not be used to communicate such matters to the auditee. Because all reportable findings are included in the schedule, there is no need for the auditor to refer to a management letter in the report on compliance with requirements applicable to each major federal program and internal control over compliance in accordance with A-133.

Reportable Conditions. A-133 requires the auditor to report as an audit finding reportable conditions in internal control over compliance with major programs. The auditor's determination of whether a deficiency in internal control over compliance 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*. (See the further discussion of this level of reporting in the next section.) A-133 also requires the auditor to identify reportable condition audit findings that are individually or cumulatively material weaknesses.

Material Noncompliance. Auditors are required to report findings for material noncompliance with the laws, regulations, and provisions of contracts and grant agreements related to major programs. The auditor's determination of whether noncompliance is material for the purpose of reporting an audit finding is in relation to either of the following:

1. A type of compliance requirement
2. An audit objective identified in the *Compliance Supplement*

To determine whether instances of noncompliance are to be reported as audit findings, the auditor usually considers the known and likely questioned costs arising from the noncompliance in relation to the federal expenditures for the program. However, some instances of noncompliance cannot be quantified. For example, consider a situation in which a material amount of federal expenditures for a major program is expended through subrecipients. Therefore, subrecipient monitoring could have a direct and material effect on this

⁵ GAS does not require the reporting on the status of prior-year findings if they do not affect the current-year financial statement audit. For example, if in the prior year the auditor reported a violation of a contractual provision and that prior violation does not affect the current-year audit, the auditor is not required to report the status of the finding.

program. The auditor finds that the pass-through entity consistently failed to provide its subrecipients with federal award information, including applicable compliance requirements. The auditor should consider this noncompliance in relation to a type of compliance requirement (subrecipient monitoring, in this case) or an audit objective identified in the *Compliance Supplement*. The pertinent audit objective in the *Compliance Supplement* for this example is for the auditor to determine whether a 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 stated audit objective and, therefore, should be reported as an audit finding. (The noncompliance may not have been material to the type of compliance requirement because there was no noted noncompliance with the other elements of the subrecipient monitoring requirement—namely monitoring subrecipient activities, ensuring that subrecipient audits are performed and corrective action is promptly taken, and evaluating the effect of subrecipient activity on the auditee’s ability to comply with federal regulations.) In addition, the auditor should consider whether to report a reportable condition (and possibly material weakness) in internal control over compliance.

Known and Likely Questioned Costs. Based on the definition of questioned cost in A-133, the criteria for determining and reporting questioned costs are as follows:

1. *Unallowable costs:* Certain costs that are specifically unallowable under the general and special award conditions or agency instructions (including, but not limited to, pregrant and postgrant costs and costs in excess of the approved grant budget either by category or in total)
2. *Unapproved cost:* Costs that are not provided for in the approved grant budget, or for which the provisions of contracts or grant agreements or applicable cost principles require the awarding agency’s approval but for which the auditor finds no evidence of approval
3. *Undocumented costs:* Costs charged to the grant for which adequate detailed documentation does not exist (for example, documentation demonstrating the relationship of the costs to the grant or the amounts involved)
4. *Unreasonable costs:* Costs incurred that may not reflect the actions a prudent person would take in the circumstances, or costs resulting from assigning an unreasonably high value to in-kind contributions

In quantifying unallowable costs, auditors also should consider directly associated costs that also may have been charged. Directly associated costs are costs incurred solely as a result of incurring another cost and that would not have been incurred if the other cost had not been incurred. For example, fringe benefit costs are costs that are directly associated with salary and wage costs. When an unallowable cost is incurred, directly associated costs also are unallowable.

Auditors should report an audit finding for 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. The following illustrates the application of the reporting requirement. Suppose an auditor—

1. Determines that eligibility, which is a type of compliance requirement, could have a direct and material effect on a major program.
2. Designs and conducts test over eligibility related to that major program.
3. Discovers two separate instances of noncompliance related to eligibility of \$9,000 each.

Because the auditor is required to report known questioned costs that are greater than \$10,000 for a type of compliance requirement (eligibility), the auditor should report the questioned costs of \$18,000 as an audit finding.

For major programs, the auditor also should report an audit finding for known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement.⁶ For example, the auditor may have identified only \$3,000 in questioned costs related to a type of compliance requirement for a major program but, based on the sample examined and the nature of the noncompliance identified, the auditor estimates that the likely questioned costs are in the range of \$25,000 to \$30,000. In this situation, the auditor should report an audit finding. In evaluating the effect of questioned costs on the opinions on compliance and on the financial statements, the auditor also should consider his or her best estimate of likely questioned costs, not just the known questioned costs.

Except for audit follow-up, the auditor is not required to perform any audit procedures for a federal program that is not audited as a major program. Therefore, the auditor normally will not identify questioned costs for programs that are not audited as major programs. However, if the auditor does become aware of questioned costs for those programs (for example, as part of audit follow-up or other audit procedures) and the known questioned costs are greater than \$10,000, the auditor should report an audit finding. (Note that for programs that are not audited as major, the \$10,000 requirement relates to questioned costs for the program as a whole, not just in relation to a type of compliance requirement.)

The \$10,000 threshold for reporting audit findings for questioned costs is constant, regardless of the size of federal expenditures for a particular auditee or federal program. That is, unlike the thresholds for determining Type A programs and risk assessing Type B programs, the amount does not change depending on the size of federal expenditures.

Other Findings. If the auditor's report on compliance for major federal programs is other than unqualified, the reason should be presented as an audit finding in the schedule of findings and questioned costs for federal awards. (Often, the situation already would be reported as a finding because of the reporting of material noncompliance and questioned costs greater than \$10,000.) The auditor also should report a finding for known fraud affecting a federal award. However, the auditor is not required to make an additional reporting when he or she confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of GAS.

Finally, the auditor should report an audit finding if the results of audit follow-up procedures disclose that the auditee materially misrepresented the status of any prior audit finding in the summary schedule of prior audit findings.

Audit Finding Detail

Audit findings should be presented in sufficient detail for the auditee to prepare a corrective action plan and to take corrective action and for federal agencies and pass-through entities to arrive at a management decision. The following specific information is to be included, as applicable, when reporting audit findings:

1. A reference number to allow for easy referencing of the audit findings during follow-up
2. Federal program and specific federal award identification. This should include the CFDA title and number, federal award number and year, name of federal agency, and name of the pass-through entity. If this information is not available, the auditor should provide the best information available to describe the federal award. This information should be consistent with the information provided in the schedule of expenditures of federal awards.
3. The criteria or specific requirement upon which the audit finding is based, including statutory, regulatory, or other citation

⁶ A-133 does not require the auditor to report his or her estimate of those likely questioned costs, although it does require the auditor to include information to provide proper perspective to judge the prevalence and consequences of the finding, such as whether the audit finding represents an isolated instance or a systemic problem.

4. The condition found, including facts that support the deficiency identified
5. Identification of questioned costs and how they were computed
6. The context of the finding—that is, information to provide proper perspective to judge the prevalence and consequences of the finding, such as whether the audit finding represents an isolated instance or a systemic problem (Where appropriate, instances identified should be related to the universe and the number of cases examined and should be quantified in terms of dollar value.)
7. The cause and possible asserted effect of the finding
8. Recommendations to prevent future occurrences of the deficiency
9. If practical, the views of responsible auditee officials when there is disagreement with the audit findings

An illustrative finding related to federal awards is presented in the schedule of findings and questioned costs in a case study Practice Aid to this practice guide.

THE DATA COLLECTION FORM⁷

The data collection form is an OMB-approved form that requires information about whether the audit was completed in accordance with A-133 and about the auditee, its federal programs, and the results of the audit. Using the form provides this information in a consistent format so that the federal clearinghouse can enter the information into a database. The form also requires the identification of those federal agencies providing direct federal assistance for which there are current- or prior-year audit findings, thereby allowing the clearinghouse to forward copies of the reporting package to those agencies. The form is to be signed by both a senior-level representative of the auditee and the auditor. The certification signed by the auditor indicates that the information provided in the form is not a substitute for the auditor's reports. The data collection form is separate from and should not be made a part of the reporting package, even though the form is to be submitted with the reporting package to the federal clearinghouse.

A completed data collection form, including the instructions for completing it, is included in a case study Practice Aid to this practice guide. A blank data collection form, with instructions, is presented as a separate Practice Aid. The form and access to electronic filing also may be obtained from the sources indicated in the appendix to the Practice Aids.

The data collection form requires a listing of the federal awards expended during the fiscal year. It is not acceptable to include a photocopy of the schedule of expenditures of federal awards as a substitute for completing this portion of the form. Federal expenditures for noncash assistance should be included in this part of the data collection form, even if they are reported in the notes to the schedule of expenditures of federal awards rather than on the face of that schedule.

Initial and corrected submissions of the data collection form must be done by mail; facsimile copies are not acceptable.

SUBMISSION OF THE DATA COLLECTION FORM AND THE REPORTING PACKAGE

The audit is to be completed and the data collection form⁸ and the reporting package are to be submitted by the auditee within thirty days after receipt of the auditor's reports or nine months after the end of the audit period, whichever is earlier. However, a longer period is permitted if agreed to in advance by the cognizant or oversight agency for audit.

⁷ See footnote 1 of this chapter for related information about the data collection form.

⁸ See footnote 1 of this chapter for related information about the data collection form.

The data collection form and reporting package are to be submitted to the Federal Audit Clearinghouse at the address indicated on the form.

All auditees should submit one copy of the data collection form and one or more copies of the reporting package as follows:

1. One copy for the clearinghouse to retain as an archival copy
2. One copy for each federal awarding agency when (a) the schedule of findings and questioned costs or (b) the summary schedule of prior audit findings includes the status of audit findings related to the federal awards that the federal awarding agency provided directly to the auditee

The auditor should consider reminding the auditee of these report submission requirements in a cover letter transmitting the audit reports to the auditee.

Report Submissions by Subrecipients

In addition to the submission requirements discussed above, A-133 requires subrecipients to submit to each pass-through entity one copy of the reporting package when (1) the schedule of findings and questioned costs or (2) the summary schedule of prior audit findings includes the status of audit findings related to the federal awards that the pass-through entity provided to the auditee. A-133 does not require a copy of the data collection form to be submitted to pass-through entities.

When the subrecipient is not required to submit a reporting package to a pass-through entity, the subrecipient is to provide written notification that includes the following information:

1. An audit of the subrecipient was conducted in accordance with Circular A-133
2. The period covered by the audit
3. The names, amounts, and CFDA numbers of the federal awards provided by the pass-through entity
4. A statement that the schedule of findings and questioned costs and the summary schedule of prior audit findings did not include audit findings related to the federal awards provided by the pass-through entity

In lieu of this written notification, a subrecipient may submit a copy of the reporting package to the pass-through entity.

Again, the auditor should consider reminding the auditee of these report submission requirements in a cover letter transmitting the audit reports to the auditee.

Electronic Filings

The Federal Audit Clearinghouse permits online submissions of the data collection form on its Web site. By using the online submission option, the data being submitted is subject to online edits. Although the form is submitted electronically, it still needs to be printed, signed and dated by the auditee and auditor, and mailed to the Federal Audit Clearinghouse with the appropriate number of audit reporting packages. Additional information about electronic submissions may be obtained from the Federal Audit Clearinghouse (<http://harvester.census.gov/sac/>).

Additional Submissions

Although GAAS, GAS, and A-133 do not require management letters, the auditee is required to submit a copy of any management letter received to a federal agency or pass-through entity if so requested. In addition, a federal agency or pass-through entity may request a copy of the reporting package.

AUDIT REPORTS RETENTION REQUIREMENTS

Auditees are required to keep a copy of the data collection form and one copy of the reporting package for three years from the date of submission to the federal clearinghouse. Pass-through entities are required to keep a copy of subrecipients' submissions for three years from the date of receipt.

EXHIBIT 7-1 ILLUSTRATIVE AUDITEE SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS FOR THE YEAR ENDED JUNE 30, 2000

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
(1) Audit findings that have been fully corrected:					
1999	99-1	Federal reports were not submitted on a timely basis	10.560	N/A	The system and procedures were corrected.
1998	98-8	Funds were not drawn in the proper period	66.000	\$75,000	The system and procedures were corrected.
(2) Audit findings were not corrected or partially corrected:					
1999	99-5	Adequate employee time reports were not maintained	20.205	\$123,000	New controls were to be implemented; however, this program is no longer administered.
1998	98-4	Controls were not in place to detect duplicate claims and payments	84.032	N/A	New data processing payment system has been developed and is being implemented.
(3) Corrective action taken is significantly different from corrective action previously reported:					
1998	98-6	Funds were not obligated during the allowable period	84.010	\$120,000	Controls were to be implemented to ensure funds were obligated within the carryover period; however, the entity instead established a policy to expend funds only during the period of initial availability and not to use funds during the carryover period.
(4) Audit finding is no longer valid:					
1997	97-9	Procedures did not exist for reviewing billings	14.856	\$450,000	Two years have passed, the federal agency is not following up, and a management decision was not issued.

EXHIBIT 7-2 • ILLUSTRATIVE AUDITEE CORRECTIVE ACTION PLAN FOR THE YEAR ENDED JUNE 30, 2000

Finding Number	Responsible Individual	Management Views	Corrective Action	Anticipated Completion Date
00-5	Mr. Ennis	Management agrees with the finding and the recommendation.	Supervisory approvals will be required to help ensure that only allowable costs are charged to federal programs	6/30/0X

EXHIBIT 7-3 • ILLUSTRATIVE SCHEDULE OF FINDINGS AND QUESTIONED COSTS

**Example Entity
Schedule of Findings and Questioned Costs
for the Year Ended June 30, 200X**

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? _____ yes _____ no
- Reportable condition(s) identified that are not considered to be material weaknesses? _____ yes _____ none reported
- Noncompliance material to financial statements noted? _____ yes _____ no

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? _____ yes _____ no
- Reportable condition(s) identified that are not considered to be material weakness(es)? _____ yes _____ none reported

Type of auditor’s report issued on compliance for major programs: [*unqualified, qualified, adverse, or disclaimer*]¹

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133? _____ yes _____ no

Identification of major programs:²

<i>CFDA Number(s)</i> ³	<i>Name of Federal Program or Cluster</i> ⁴

Dollar threshold used to distinguish between type A and type B programs: \$ _____

Auditee qualified as low-risk auditee? _____ yes _____ no

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 required to list only the name of the cluster, not each individual program within the cluster.

**Example Entity
Schedule of Findings and Questioned Costs
For the Year Ended June 30, 200X
(continued)**

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 chapter 5 of Government Auditing Standards. Auditors also 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 affects 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 response]⁷*

(continued)

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 2000 would be assigned reference numbers of 00-1, 00-2, and 00-3.

⁶ Provide sufficient information for judging the prevalence and consequences of the findings, 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 chapters 5 and 7 of *Government Auditing Standards* for additional guidance on reporting management's response.

EXHIBIT 7-3 • ILLUSTRATIVE SCHEDULE OF FINDINGS AND QUESTIONED COSTS (continued)

**Example Entity
Schedule of Findings and Questioned Costs
For the Year Ended June 30, 200X
(continued)**

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 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, regulator, or other citation)*
- *Condition*¹⁰
- *Questioned costs*¹¹
- *Context*¹²
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response*¹³

⁸ See footnote 5 of this exhibit.

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 of this exhibit.

¹³ To the extent practical, indicate when management does not agree with the finding, questioned cost, or both.

CHAPTER 8: Program-Specific Audits

INTRODUCTION

A program-specific audit is an audit of one federal program. § _____.200 of Office of Management and Budget (OMB) Circular A-133 (A-133) provides that when an auditee expends federal awards under only one federal program (except research and development—R&D) and the program's laws, regulations, or contracts or grant agreements do not require a financial statement audit, the auditee may elect to have a program-specific audit conducted in accordance with § _____.235. For example, auditees may not elect to have a program-specific audit for the Student Financial Aid (SFA) program cluster because U.S. Department of Education regulations require a financial statement audit for those programs.

A program-specific audit may not be elected for R&D unless—

1. All of the federal awards expended were received from the same federal agency, or the same federal agency and the same pass-through entity.
2. That federal agency or pass-through entity approves a program-specific audit in advance.

The audit period for a program-specific audit need not coincide with the auditee's fiscal year; it could be for a different federal funding year.

A checklist for a program-specific audit is presented as a Practice Aid to this practice guide.

PROGRAM-SPECIFIC AUDIT GUIDES

Auditors engaged to perform a program-specific audit should contact the Office of Inspector General of the awarding federal agency to determine whether a program-specific audit guide is available or consult the sources listed in the appendix to the Practice Aids.

The process for performing and reporting on a program-specific audit differs depending on whether a program-specific audit guide is available. The following sections discuss those differences.

Program-Specific Audit Guide Available

Generally, a program-specific audit guide provides guidance to the auditor with respect to internal control and compliance requirements, suggested audit procedures, and audit reporting requirements. When a current program-specific audit guide is available, the auditor should conduct the audit and prepare reports in accordance with the guide. In addition, the audit is to be conducted in accordance with GAS. If there have been significant changes made to a program's compliance requirements and the related program-specific audit guide has not been updated to reflect those changes, the auditor should follow § _____.235 of A-133 and the *Compliance Supplement* for guidance; that is, the auditor should follow the guidance below as if a program-specific audit guide is not available. Further, if a program-specific audit guide does not reflect changes to current authoritative standards and guidance, such as revisions to generally accepted auditing standards (GAAS) and *Government Auditing Standards* (GAS), the audit should follow current applicable authoritative standards and guidance rather than the outdated guidance in the audit guide.

Program-Specific Audit Guide Not Available

When a program-specific audit guide is not available, the auditee is required to prepare the following:

1. Financial statement(s) for the federal program that includes, at a minimum, a schedule of expenditures of federal awards for the program

2. Notes that describe the significant accounting policies used in preparing the schedule
3. A summary schedule of prior audit findings consistent with the requirements of § _____.315(b)
4. A corrective action plan consistent with the requirements of § _____.315(c)

When a program-specific audit guide is not available, the auditor is required to:

1. Perform an audit of the financial statement(s) for the federal program in accordance with GAAS and GAS
2. Obtain an understanding of and perform tests of internal control over the federal program consistent with the requirements of § _____.500(c) for a major program
3. Perform procedures to determine whether the auditee has complied with the laws, regulations, and 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
4. Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings, and report a finding if the summary schedule of prior audit findings contains a material misrepresentation (See the Practice Aid for illustrative audit procedures on the summary schedule of prior audit findings.)

In performing procedures related to internal control and compliance over the federal program, the auditor should follow the guidance in Part 7 of the *Compliance Supplement*.

When a program-specific audit guide is not available, the auditor's reports must state that the audit was conducted in accordance with GAAS, GAS, and OMB Circular A-133 and include the following:

1. An opinion (or disclaimer of opinion) about whether the financial statement(s) of the federal program is presented fairly in all material respects in accordance with the stated accounting policies
2. Reporting on internal control related to the federal program describing the scope of testing of internal control and the results of the tests
3. Reporting on compliance that includes an opinion (or disclaimer of opinion) about whether the auditee complied with the laws, regulations, and provisions of contracts or grant agreements that could have a direct and material effect on the federal program
4. A schedule of findings and questioned costs for the federal program that includes a summary of the auditor's results related 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)

REPORT SUBMISSION FOR PROGRAM-SPECIFIC AUDITS

The audit should be completed and the required reports should be submitted within the earlier of thirty 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 awarding agency or a different period is specified in the program-specific audit guide.

Program-Specific Audit Guide Available

The auditee should submit the reports required by the program-specific audit guide to the federal clearinghouse at the address indicated in chapter 8 of this practice guide and to the federal awarding agency or pass-through entity in accordance with the requirements of the federal audit guide. It also should submit the data collection form prepared in accordance with § _____.320(b) of A-133 to the federal clearinghouse.

Program-Specific Audit Guide Not Available

If a program-specific audit guide is not available, the reporting package consists of the financial statement(s) of the federal program, a summary schedule of prior audit findings, a corrective action plan, and the auditor's report(s), including a schedule of findings and questioned costs. The auditee should submit one copy of this reporting package and the data collection form prepared in accordance with § _____.320(b) of A-133 to the federal clearinghouse. Also, if the reports disclose current- or prior-year findings, the auditee should submit one copy of the reporting package to the federal clearinghouse for 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 if there are no current- or prior-year findings, the subrecipient may provide written notification to the pass-through entity stating that an A-133 audit was performed and that there were no findings. (The subrecipient may elect to send a copy of the reporting package rather than the written notification.) In an effort to make program-specific audit reporting understandable and to reduce the number of reports issued, SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, recommends that the following reports be issued for a program-specific audit:

- Opinion on the financial statement(s) of the federal program
- Report on compliance with requirements applicable to the federal program and internal control over compliance in accordance with the program-specific audit option under A-133

See the following paragraph for a discussion of the possible issuance of a separate report to meet the reporting requirements of GAS. Illustrative program-specific audit reports from SOP 98-3 are presented as Practice Aids to this practice guide.

If the financial statements of the program include only the activity of the federal program, the auditor is not required to issue a separate report on internal control over financial reporting and compliance to meet the reporting requirements of GAS. This is because, in many cases, the financial statements of the program are the equivalent of the schedule of expenditures of federal awards. In this situation, the two reports listed above and illustrated as Practice Aids would meet all of the reporting requirements of both GAS and A-133. However, the auditor has the option of issuing a separate GAS report in addition to the two reports described above. Although not as common, the financial statements may include more than federal program activity (such as, a municipal sewer district that issues financial statements that include both normal operations and federal program activity related to a grant that was obtained for the purpose of building a new sewage treatment facility). In this situation, the auditor should issue a separate GAS report as illustrated in the Practice Aids portion of this practice guide and modify it so that it refers only to the financial statements of the federal program.

OTHER REQUIREMENTS

Unless contrary to the program-specific audit provisions of A-133, the program-specific audit guide, or program laws and regulations, program-specific audits are subject to the following sections of A-133, if applicable:

§ _____.100	Purpose
§ _____.105	Definitions
§ _____.200	Audit requirements
§ _____.205	Basis for determining federal awards expended
§ _____.210	Subrecipient and vendor determinations
§ _____.215(a) and (b)	Relation to other audit requirements
§ _____.220	Frequency of audits
§ _____.225	Sanctions

§ _____.230	Audit costs
§ _____.300	Auditee responsibilities
§ _____.305	Auditor selection
§ _____.315	Audit findings follow-up
§ _____.320(f) through (j)	Report submission
§ _____.400	Responsibilities—federal agencies and pass-through entities
§ _____.405	Management decision
§ _____.510	Audit findings
§ _____.515	Audit working papers

APPENDIX A: Single Audit Act Amendments of 1996, P.L. No. 104-156

110 STAT. 1396

PUBLIC LAW 104-156—JULY 5, 1996

Public Law 104-156 104th Congress

An Act

July 5, 1996
[S. 1579]

Single Audit Act
Amendments of
1996.
31 USC 7501
note.

To streamline and improve the effectiveness of chapter 75 of title 31, United States Code (commonly referred to as the "Single Audit Act").

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

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“(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

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purposes of this chapter, performance audits shall not be required except as authorized by the Director.

“(d) Each single audit conducted pursuant to subsection (a) for any fiscal year shall—

“(1) cover the operations of the entire non-Federal entity;

or

“(2) at the option of such non-Federal entity such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and organizational unit, which shall be considered to be a non-Federal entity.

“(e) The auditor shall—

“(1) determine whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles;

“(2) determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole;

“(3) with respect to internal controls pertaining to the compliance requirements for each major program—

“(A) obtain an understanding of such internal controls;

“(B) assess control risk; and

“(C) perform tests of controls unless the controls are deemed to be ineffective; and

“(4) determine whether the non-Federal entity has complied with the provisions of laws, regulations, and contracts or grants pertaining to Federal awards that have a direct and material effect on each major program.

“(f)(1) Each Federal agency which provides Federal awards to a recipient shall—

“(A) provide such recipient the program names (and any identifying numbers) from which such awards are derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter; and

“(B) review the audit of a recipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the recipient by the Federal agency.

“(2) Each pass-through entity shall—

“(A) provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;

“(B) monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;

“(C) review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and

“(D) require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the pass-through entity to have such

access to the subrecipient's records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

“(g)(1) The auditor shall report on the results of any audit conducted pursuant to this section, in accordance with guidance issued by the Director. 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 timeframe authorized by the Federal agency, determined under criteria issued under section 7504, when the 9-month timeframe 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.

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“(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).

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“§ 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

- Sec.
- ____.100 Purpose.
 - ____.105 Definitions.

Subpart B—Audits

- ____.200 Audit requirements.
- ____.205 Basis for determining Federal awards expended.
- ____.210 Subrecipient and vendor determinations.
- ____.215 Relation to other audit requirements.
- ____.220 Frequency of audits.
- ____.225 Sanctions.
- ____.230 Audit costs.
- ____.235 Program-specific audits.

Subpart C—Auditees

- ____.300 Auditee responsibilities.
- ____.305 Auditor selection.
- ____.310 Financial statements.
- ____.315 Audit findings follow-up.
- ____.320 Report submission.

Subpart D—Federal Agencies and Pass-Through Entities

- ____.400 Responsibilities.
- ____.405 Management decision.

Subpart E—Auditors

- ____.500 Scope of audit.
- ____.505 Audit reporting.
- ____.510 Audit findings.
- ____.515 Audit working papers.
- ____.520 Major program determination.
- ____.525 Criteria for Federal program risk.
- ____.530 Criteria for a low-risk auditee.

Appendix A to Part ____—Data Collection Form (Form SF-SAC)

Appendix B to Part ____—Circular A-133 Compliance Supplement

Subpart A—General

§ _____.100 Purpose.

This part sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of non-Federal entities expending Federal awards.

§ _____.105 Definitions.

Auditee means any non-Federal entity that expends Federal awards which must be audited under this part.

Auditor means an auditor, that is a public accountant or a Federal, State or local government audit organization, which meets the general standards specified in generally accepted government auditing standards (GAGAS). The term auditor does not include internal auditors of non-profit organizations.

Audit finding means deficiencies which the auditor is required by § 510(a) to report in the schedule of findings and questioned costs.

CFDA number means the number assigned to a Federal program in the *Catalog of Federal Domestic Assistance (CFDA)*.

Cluster of programs means a grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development (R&D), student financial aid (SFA), and other clusters. "Other clusters" are as defined by the Office of Management and Budget (OMB) in the compliance supplement or as designated by a State for Federal awards the State provides to its subrecipients that meet the definition of a cluster of programs. When designating an "other cluster," a State shall identify the Federal awards included in the cluster and advise the subrecipients of compliance requirements applicable to the cluster, consistent with § 400(d)(1) and § 400(d)(2), respectively. A cluster of programs shall be considered as one program for determining major programs, as described in § 520, and, with the exception of R&D as described in § 200(c), whether a program-specific audit may be elected.

Cognizant agency for audit means the Federal agency designated to carry out the responsibilities described in § 400(a).

Compliance supplement refers to the *Circular A-133 Compliance Supplement*, included as Appendix B to Circular A-133, or such documents as OMB or its designee may issue to replace it.

This document is available from the Government Printing Office, Superintendent of Documents, Washington, DC 20402-9325.

Corrective action means action taken by the auditee that:

- (1) Corrects identified deficiencies;
- (2) Produces recommended improvements; or
- (3) Demonstrates that audit findings are either invalid or do not warrant auditee action.

Federal agency has the same meaning as the term *agency* in Section 551(1) of title 5, United States Code.

Federal award means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors. Any audits of such vendors shall be covered by the

terms and conditions of the contract. Contracts to operate Federal Government owned, contractor operated facilities (GOCOs) are excluded from the requirements of this part.

Federal awarding agency means the Federal agency that provides an award directly to the recipient.

Federal financial assistance means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance, but does not include amounts received as reimbursement for services rendered to individuals as described in § 205(h) and § 205(i).

Federal program means:

- (1) All Federal awards to a non-Federal entity assigned a single number in the CFDA.
- (2) When no CFDA number is assigned, all Federal awards from the same agency made for the same purpose should be combined and considered one program.
- (3) Notwithstanding paragraphs (1) and (2) of this definition, a cluster of programs. The types of clusters of programs are:

- (i) Research and development (R&D);
- (ii) Student financial aid (SFA); and
- (iii) "Other clusters," as described in the definition of cluster of programs in this section.

GAGAS means generally accepted government auditing standards issued by the Comptroller General of the United States, which are applicable to financial audits.

Generally accepted accounting principles has the meaning specified in generally accepted auditing standards issued by the American Institute of Certified Public Accountants (AICPA).

Indian tribe means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

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

- (1) Effectiveness and efficiency of operations;

- (2) Reliability of financial reporting; and
- (3) Compliance with applicable laws and regulations.

Internal control pertaining to the compliance requirements for Federal programs (Internal control over Federal programs) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for Federal programs:

- (1) Transactions are properly recorded and accounted for to:

- (i) Permit the preparation of reliable financial statements and Federal reports;
- (ii) Maintain accountability over assets; and
- (iii) Demonstrate compliance with laws, regulations, and other compliance requirements;

- (2) Transactions are executed in compliance with:

- (i) Laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on a Federal program; and

- (ii) Any other laws and regulations that are identified in the compliance supplement; and

- (3) Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Loan means a Federal loan or loan guarantee received or administered by a non-Federal entity.

Local government means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

Major program means a Federal program determined by the auditor to be a major program in accordance with § 520 or a program identified as a major program by a Federal agency or pass-through entity in accordance with § 215(c).

Management decision means the evaluation by the Federal awarding agency or pass-through entity of the audit findings and corrective action plan and the issuance of a written decision as to what corrective action is necessary.

Non-Federal entity means a State, local government, or non-profit organization.

Non-profit organization means:

- (1) any corporation, trust, association, cooperative, or other organization that:

(i) Is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;

(ii) Is not organized primarily for profit; and

(iii) Uses its net proceeds to maintain, improve, or expand its operations; and

(2) The term *non-profit organization* includes non-profit institutions of higher education and hospitals.

OMB means the Executive Office of the President, Office of Management and Budget.

Oversight agency for audit means the Federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit. When there is no direct funding, the Federal agency with the predominant indirect funding shall assume the oversight responsibilities. The duties of the oversight agency for audit are described in § _____.400(b).

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 addtee 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 addtee, the addtee 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 addtee that owns or operates a FFRDC may elect to treat the FFRDC as a separate entity for purposes of this part.

§ _____.206 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.

(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 addatee 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 addatee 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 addatee, 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 § 200.520 and, if not, the estimated incremental cost. The Federal agency shall then promptly confirm to the addatee 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 addatee 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 addatee 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 addatee 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 addatee 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 addatee, 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 § 320(d)(1) and findings and questioned costs consistent with the requirements of § 320(d)(3).

(c) **Report submission for program-specific audits.** (1) The audit shall be completed and the reporting required by paragraph (c)(2) or (c)(3) of this section submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the Federal agency that provided the funding or a different period is specified in a program-specific audit guide. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the required reporting shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period, unless a different period is specified in a program-specific audit guide.) Unless restricted by law or regulation, the auditee shall make report copies available for public inspection.

(2) When a program-specific audit guide is available, the auditee shall submit to the Federal clearinghouse designated by OMB the data collection form prepared in accordance with § 320(b), as applicable to a program-specific audit, and the reporting required by the program-specific audit guide to be retained as an archival copy. Also, the auditee shall submit to the Federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

(3) When a program-specific audit guide is not available, the reporting package for a program-specific audit shall consist of the financial statement(s) of the Federal program, a summary schedule of prior audit findings, and a corrective action plan as described in paragraph (b)(2) of this

section, and the auditor's report(s) described in paragraph (b)(4) of this section. The data collection form prepared in accordance with § 320(b), as applicable to a program-specific audit, and one copy of this reporting package shall be submitted to the Federal clearinghouse designated by OMB to be retained as an archival copy. Also, when the schedule of findings and questioned costs disclosed audit findings or the summary schedule of prior audit findings reported the status of any audit findings, the auditee shall submit one copy of the reporting package to the Federal clearinghouse on behalf of the Federal awarding agency, or directly to the pass-through entity in the case of a subrecipient. Instead of submitting the reporting package to the pass-through entity, when a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient shall provide written notification to the pass-through entity, consistent with the requirements of § 320(e)(2). A subrecipient may submit a copy of the reporting package to the pass-through entity to comply with this notification requirement.

(d) Other sections of this part may apply. Program-specific audits are subject to § 100 through § 215(b), § 220 through § 230, § 300 through § 305, § 315, § 320(f) through § 320(j), § 400 through § 405, § 510 through § 515, and other referenced provisions of this part unless contrary to the provisions of this section, a program-specific audit guide, or program laws and regulations.

Subpart C—Auditees

§ 300 Auditee responsibilities.

The auditee shall:

(a) Identify, in its accounts, all Federal awards received and expended and the Federal programs under which they were received. Federal program and award identification shall include, as applicable, the CFDA title and number, award number and year, name of the Federal agency, and name of the pass-through entity.

(b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs.

(c) Comply with laws, regulations, and the provisions of contracts or grant

agreements related to each of its Federal programs.

(d) Prepare appropriate financial statements, including the schedule of expenditures of Federal awards in accordance with § 310.

(e) Ensure that the audits required by this part are properly performed and submitted when due. When extensions to the report submission due date required by § 320(a) are granted by the cognizant or oversight agency for audit, promptly notify the Federal clearinghouse designated by OMB and each pass-through entity providing Federal awards of the extension.

(f) Follow up and take corrective action on audit findings, including preparation of a summary schedule of prior audit findings and a corrective action plan in accordance with § 315(b) and § 315(c), respectively.

§ 305 Auditor selection.

(a) **Auditor procurement.** In procuring audit services, auditees shall follow the procurement standards prescribed by the Grants Management Common Rule (hereinafter referred to as the "A-102 Common Rule") published March 11, 1988 and amended April 19, 1995 [insert appropriate CFR citation], Circular A-110, "Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations," or the FAR (48 CFR part 42), as applicable (OMB Circulars are available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503). Whenever possible, auditees shall make positive efforts to utilize small businesses, minority-owned firms, and women's business enterprises, in procuring audit services as stated in the A-102 Common Rule, OMB Circular A-110, or the FAR (48 CFR part 42), as applicable. In requesting proposals for audit services, the objectives and scope of the audit should be made clear. Factors to be considered in evaluating each proposal for audit services include the responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality control reviews, and price.

(b) **Restriction on auditor preparing indirect cost proposals.** An auditor who prepares the indirect cost proposal or cost allocation plan may not also be selected to perform the audit required by this part when the indirect costs recovered by the auditee during the prior year exceeded \$1 million. This

restriction applies to the base year used in the preparation of the indirect cost proposal or cost allocation plan and any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. To minimize any disruption in existing contracts for audit services, this paragraph applies to audits of fiscal years beginning after June 30, 1998.

(c) *Use of Federal auditors.* Federal auditors may perform all or part of the work required under this part if they comply fully with the requirements of this part.

§ ____ .310 Financial statements.

(a) *Financial statements.* The auditee shall prepare financial statements that reflect its financial position, results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements shall be for the same organizational unit and fiscal year that is chosen to meet the requirements of this part. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits in accordance with § ____ .500(a) and prepare separate financial statements.

(b) *Schedule of expenditures of Federal awards.* The auditee shall also prepare a schedule of expenditures of Federal awards for the period covered by the auditee's financial statements. While not required, the auditee may choose to provide information requested by Federal awarding agencies and pass-through entities to make the schedule easier to use. For example, when a Federal program has multiple award years, the auditee may list the amount of Federal awards expended for each award year separately. At a minimum, the schedule shall:

(1) List individual Federal programs by Federal agency. For Federal programs included in a cluster of programs, list individual Federal programs within a cluster of programs. For R&D, total Federal awards expended shall be shown either by individual award or by Federal agency and major subdivision within the Federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services.

(2) For Federal awards received as a subrecipient, the name of the pass-through entity and identifying number assigned by the pass-through entity shall be included.

(3) Provide total Federal awards expended for each individual Federal program and the CFDA number or other

identifying number when the CFDA information is not available.

(4) Include notes that describe the significant accounting policies used in preparing the schedule.

(5) To the extent practical, pass-through entities should identify in the schedule the total amount provided to subrecipients from each Federal program.

(6) Include, in either the schedule or a note to the schedule, the value of the Federal awards expended in the form of non-cash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end. While not required, it is preferable to present this information in the schedule.

§ ____ .315 Audit findings follow-up.

(a) *General.* The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee shall prepare a summary schedule of prior audit findings. The auditee shall also prepare a corrective action plan for current year audit findings. The summary schedule of prior audit findings and the corrective action plan shall include the reference numbers the auditor assigns to audit findings under § ____ .510(c). Since the summary schedule may include audit findings from multiple years, it shall include the fiscal year in which the finding initially occurred.

(b) *Summary schedule of prior audit findings.* The summary schedule of prior audit findings shall report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to Federal awards. The summary schedule shall also include audit findings reported in the prior audit's summary schedule of prior audit findings except audit findings listed as corrected in accordance with paragraph (b)(1) of this section, or no longer valid or not warranting further action in accordance with paragraph (b)(4) of this section.

(1) When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.

(2) When audit findings were not corrected or were only partially corrected, the summary schedule shall describe the planned corrective action as well as any partial corrective action taken.

(3) When corrective action taken is significantly different from corrective action previously reported in a corrective action plan or in the Federal agency's or pass-through entity's management decision, the summary schedule shall provide an explanation.

(4) When the auditee believes the audit findings are no longer valid or do not warrant further action, the reasons for this position shall be described in the summary schedule. A valid reason for considering an audit finding as not warranting further action is that all of the following have occurred:

(i) Two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse;

(ii) The Federal agency or pass-through entity is not currently following up with the auditee on the audit finding; and

(iii) A management decision was not issued.

(c) *Corrective action plan.* At the completion of the audit, the auditee shall prepare a corrective action plan to address each audit finding included in the current year auditor's reports. The corrective action plan shall provide the name(s) of the contact person(s) responsible for corrective action, the corrective action planned, and the anticipated completion date. If the auditee does not agree with the audit findings or believes corrective action is not required, then the corrective action plan shall include an explanation and specific reasons.

§ ____ .320 Report submission.

(a) *General.* The audit shall be completed and the data collection form described in paragraph (b) of this section and reporting package described in paragraph (c) of this section shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the data collection form and reporting package shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period.) Unless restricted by law or regulation, the auditee shall make copies available for public inspection.

(b) *Data Collection.* (1) The auditee shall submit a data collection form which states whether the audit was completed in accordance with this part and provides information about the auditee, its Federal programs, and the results of the audit. The form shall be approved by OMB, available from the Federal clearinghouse designated by OMB, and include data elements similar to those presented in this paragraph. A senior level representative of the auditee (e.g., State controller, director of

finance, chief executive officer, or chief financial officer) shall sign a statement to be included as part of the form certifying that: the auditee complied with the requirements of this part, the form was prepared in accordance with this part (and the instructions accompanying the form), and the information included in the form, in its entirety, are accurate and complete.

(2) The data collection form shall include the following data elements:

(i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).

(ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.

(iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee.

(iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.

(v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).

(vi) A list of the Federal awarding agencies which will receive a copy of the reporting package pursuant to § 320(d)(2).

(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.

§ 406 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.

§ _____. 610 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.

§ 515.615 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.

§ 520.520 Major program determination.

(a) *General.* The auditor shall use a risk-based approach to determine which Federal programs are major programs. This risk-based approach shall include consideration of: Current and prior audit experience, oversight by Federal agencies and pass-through entities, and the inherent risk of the Federal program. The process in paragraphs (b) through (i) of this section shall be followed.

(b) *Step 1.* (1) The auditor shall identify the larger Federal programs, which shall be labeled Type A programs. Type A programs are defined as Federal programs with Federal awards expended during the audit period exceeding the larger of:

(i) \$300,000 or three percent (.03) of total Federal awards expended in the case of an auditee for which total Federal awards expended equal or exceed \$300,000 but are less than or equal to \$100 million.

(ii) \$3 million or three-tenths of one percent (.003) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$100 million but are less than or equal to \$10 billion.

(iii) \$30 million or 15 hundredths of one percent (.0015) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$10 billion.

(2) Federal programs not labeled Type A under paragraph (b)(1) of this section shall be labeled Type B programs.

(3) The inclusion of large loan and loan guarantees (loans) should not result in the exclusion of other programs as Type A programs. When a Federal program providing loans significantly affects the number or size of Type A

programs, the auditor shall consider this Federal program as a Type A program and exclude its values in determining other Type A programs.

(4) For biennial audits permitted under § 220, the determination of Type A and Type B programs shall be based upon the Federal awards expended during the two-year period.

(c) *Step 2.* (1) The auditor shall identify Type A programs which are low-risk. For a Type A program to be considered low-risk, it shall have been audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and, in the most recent audit period, it shall have had no audit findings under

§ 510(a). However, the auditor may use judgment and consider that audit findings from questioned costs under § 510(a)(3) and § 510(a)(4), fraud under § 510(a)(6), and audit follow-up for the summary schedule of prior audit findings under

§ 510(a)(7) do not preclude the Type A program from being low-risk.

The auditor shall consider: the criteria in § 525(c), § 525(d)(1), § 525(d)(2), and § 525(d)(3); the results of audit follow-up; whether any changes in personnel or systems affecting a Type A program have significantly increased risk; and apply professional judgment in determining whether a Type A program is low-risk.

(2) Notwithstanding paragraph (c)(1) of this section, OMB may approve a Federal awarding agency's request that a Type A program at certain recipients may not be considered low-risk. For example, it may be necessary for a large Type A program to be audited as major each year at particular recipients to allow the Federal agency to comply with the Government Management Reform Act of 1994 (31 U.S.C. 3515). The Federal agency shall notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year to be audited of OMB's approval.

(d) *Step 3.* (1) The auditor shall identify Type B programs which are high-risk using professional judgment and the criteria in § 525. However, should the auditor select Option 2 under Step 4 (paragraph (e)(2)(i)(B) of this section), the auditor is not required to identify more high-risk Type B programs than the number of low-risk Type A programs. Except for known reportable conditions in internal control or compliance problems as discussed in § 525(b)(1), § 525(b)(2), and § 525(c)(1), a single criteria in § 525 would seldom cause a Type B program to be considered high-risk.

(2) The auditor is not expected to perform risk assessments on relatively small Federal programs. Therefore, the auditor is only required to perform risk assessments on Type B programs that exceed the larger of:

(i) \$100,000 or three-tenths of one percent (.003) of total Federal awards expended when the auditee has less than or equal to \$100 million in total Federal awards expended.

(ii) \$300,000 or three-hundredths of one percent (.0003) of total Federal awards expended when the auditee has more than \$100 million in total Federal awards expended.

(e) Step 4. At a minimum, the auditor shall audit all of the following as major programs:

(1) All Type A programs, except the auditor may exclude any Type A programs identified as low-risk under Step 2 (paragraph (c)(1) of this section).

(2) (i) High-risk Type B programs as identified under either of the following two options:

(A) *Option 1.* At least one half of the Type B programs identified as high-risk under Step 3 (paragraph (d) of this section), except this paragraph

(e)(2)(i)(A) does not require the auditor to audit more high-risk Type B programs than the number of low-risk Type A programs identified as low-risk under Step 2.

(B) *Option 2.* One high-risk Type B program for each Type A program identified as low-risk under Step 2.

(ii) When identifying which high-risk Type B programs to audit as major under either Option 1 or 2 in paragraph (e)(2)(i)(A) or (B) of this section, the auditor is encouraged to use an approach which provides an opportunity for different high-risk Type B programs to be audited as major over a period of time.

(3) Such additional programs as may be necessary to comply with the percentage of coverage rule discussed in paragraph (f) of this section. This paragraph (e)(3) may require the auditor to audit more programs as major than the number of Type A programs.

(f) *Percentage of coverage rule.* The auditor shall audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 50 percent of total Federal awards expended. If the auditee meets the criteria in § ____ 530 for a low-risk auditee, the auditor need only audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 25 percent of total Federal awards expended.

(g) *Documentation of risk.* The auditor shall document in the working papers

the risk analysis process used in determining major programs.

(h) *Auditor's judgment.* When the major program determination was performed and documented in accordance with this part, the auditor's judgment in applying the risk-based approach to determine major programs shall be presumed correct. Challenges by Federal agencies and pass-through entities shall only be for clearly improper use of the guidance in this part. However, Federal agencies and pass-through entities may provide auditors guidance about the risk of a particular Federal program and the auditor shall consider this guidance in determining major programs in audits not yet completed.

(i) *Deviation from use of risk criteria.* For first-year audits, the auditor may elect to determine major programs as all Type A programs plus any Type B programs as necessary to meet the percentage of coverage rule discussed in paragraph (f) of this section. Under this option, the auditor would not be required to perform the procedures discussed in paragraphs (c), (d), and (e) of this section.

(1) A first-year audit is the first year the entity is audited under this part or the first year of a change of auditors.

(2) To ensure that a frequent change of auditors would not preclude audit of high-risk Type B programs, this election for first-year audits may not be used by an auditee more than once in every three years.

§ ____ 525 Criteria for Federal program risk.

(a) *General.* The auditor's determination should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the Federal program. The auditor shall use auditor judgment and consider criteria, such as described in paragraphs (b), (c), and (d) of this section, to identify risk in Federal programs. Also, as part of the risk analysis, the auditor may wish to discuss a particular Federal program with auditee management and the Federal agency or pass-through entity.

(b) *Current and prior audit experience.* (1) Weaknesses in internal control over Federal programs would indicate higher risk. Consideration should be given to the control environment over Federal programs and such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements and the competence and experience of personnel who administer the Federal programs.

(i) A Federal program administered under multiple internal control structures may have higher risk. When assessing risk in a large single audit, the auditor shall consider whether weaknesses are isolated in a single operating unit (e.g., one college campus) or pervasive throughout the entity.

(ii) When significant parts of a Federal program are passed through to subrecipients, a weak system for monitoring subrecipients would indicate higher risk.

(iii) The extent to which computer processing is used to administer Federal programs, as well as the complexity of that processing, should be considered by the auditor in assessing risk. New and recently modified computer systems may also indicate risk.

(2) Prior audit findings would indicate higher risk, particularly when the situations identified in the audit findings could have a significant impact on a Federal program or have not been corrected.

(3) Federal programs not recently audited as major programs may be of higher risk than Federal programs recently audited as major programs without audit findings.

(c) *Oversight exercised by Federal agencies and pass-through entities.* (1) Oversight exercised by Federal agencies or pass-through entities could indicate risk. For example, recent monitoring or other reviews performed by an oversight entity which disclosed no significant problems would indicate lower risk. However, monitoring which disclosed significant problems would indicate higher risk.

(2) Federal agencies, with the concurrence of OMB, may identify Federal programs which are higher risk. OMB plans to provide this identification in the compliance supplement.

(d) *Inherent risk of the Federal program.* (1) The nature of a Federal program may indicate risk. Consideration should be given to the complexity of the program and the extent to which the Federal program contracts for goods and services. For example, Federal programs that disburse funds through third party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high-risk for time and effort reporting, but otherwise be at low-risk.

(2) The phase of a Federal program in its life cycle at the Federal agency may indicate risk. For example, a new Federal program with new or interim regulations may have higher risk than an established program with time-tested regulations. Also, significant changes in Federal programs, laws, regulations, or

the provisions of contracts or grant agreements may increase risk.

(3) The phase of a Federal program in its life cycle at the auditee may indicate risk. For example, during the first and last years that an auditee participates in a Federal program, the risk may be higher due to start-up or closeout of program activities and staff.

(4) Type B programs with larger Federal awards expended would be of higher risk than programs with substantially smaller Federal awards expended.

§ ____ .530 Criteria for a low-risk auditee.

An auditee which meets all of the following conditions for each of the preceding two years (or, in the case of biennial audits, preceding two audit periods) shall qualify as a low-risk auditee and be eligible for reduced audit coverage in accordance with § ____ .520:

(a) Single audits were performed on an annual basis in accordance with the provisions of this part. A non-Federal entity that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.

(b) The auditor's opinions on the financial statements and the schedule of expenditures of Federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of Federal awards and provide a waiver.

(c) There were no deficiencies in internal control which were identified as material weaknesses under the requirements of GAGAS. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of Federal awards and provide a waiver.

(d) None of the Federal programs had audit findings from any of the following in either of the preceding two years (or, in the case of biennial audits, preceding two audit periods) in which they were classified as Type A programs:

(1) Internal control deficiencies which were identified as material weaknesses;

(2) Noncompliance with the provisions of laws, regulations, contracts, or grant agreements which have a material effect on the Type A program; or

(3) Known or likely questioned costs that exceed five percent of the total Federal awards expended for a Type A program during the year.

Appendix A to Part ____—Data Collection Form (Form SF-SAC)

[insert SF-SAC after finalized]

Appendix B to Part ____—Circular A-133 Compliance Supplement

Note: Provisional OMB Circular A-133 Compliance Supplement is available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503.

[FR Doc. 97-16965 Filed 6-27-97; 8:45 am]

BILLING CODE 3110-01-P

