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Proposed statement on auditing standards :
Compliance auditing considerations in audits of
governmental entities and other recipients of
governmental financial assistance; Compliance
auditing considerations in audits of governmental
entities and other recipients of governmental
financial assistance

American Institute of Certified Public Accountants. Auditing Standards Board

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EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

COMPLIANCE AUDITING CONSIDERATIONS IN AUDITS OF GOVERNMENTAL ENTITIES AND OTHER RECIPIENTS OF GOVERNMENTAL FINANCIAL ASSISTANCE

*(To Supersede SAS No. 68, Compliance Auditing Applicable
to Governmental Entities and Other Recipients of
Governmental Financial Assistance)*

MAY 12, 1994

Prepared by the Auditing Standards Board
American Institute of Certified Public Accountants

Comments should be received by July 29, 1994, and addressed to A. Louise Williamson,
Technical Manager, Auditing Standards Division, File 2357
AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775

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May 12, 1994

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board, of a proposed statement on auditing standards that, when final, would supersede Statement on Auditing Standards No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*. A summary of the proposed Statement also accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. To facilitate consideration of responses by the Auditing Standards Board, comments should refer to specific paragraphs and include supporting reasons for each suggestion or comment.

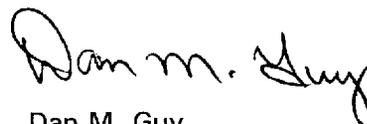
In developing guidance, the Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audit engagements. It also considers the differences an auditor may encounter in an audit engagement involving small entities and, when appropriate, makes special provisions to meet those needs. Thus, the Board would particularly appreciate comments on those matters.

Written comments on the exposure draft will become part of the public record of the AICPA Auditing Standards Division and will be available for public inspection at the offices of the AICPA after August 31, 1994, for one year. Responses should be sent to A. Louise Williamson, Technical Manager, Auditing Standards Division, File 2357, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 in time to be received by July 29, 1994.

Sincerely,



John B. Sullivan
Chair
Auditing Standards Board



Dan M. Guy
Vice President
Auditing

SUMMARY

Why Issued

The Auditing Standards Board is issuing this proposed statement on auditing standards to revise the guidance contained in Statement on Auditing Standards (SAS) No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801). This proposed Statement would provide generic guidance to practitioners engaged to perform compliance audits of governmental entities and other recipients of governmental financial assistance. In addition, this proposed Statement would not require frequent revision and updating because it does not identify compliance requirements or specify the form of reporting.

What It Does

This proposed Statement —

- a. Recognizes three levels of audits (generally accepted auditing standards, *Government Auditing Standards*, and certain other federal requirements) of recipients of governmental financial assistance.
- b. Reduces the level of detail included in the auditing standards. (Specific performance and reporting guidance would be included, more appropriately, in the applicable audit and accounting guides and statements of position.)

How It Affects Existing Standards

This proposed Statement would supersede SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*. Furthermore, as a consequence of the foregoing change, the proposed Statement would require conforming changes to and updating of the guidance in related statements of position and audit and accounting guides.

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PROPOSED STATEMENT ON AUDITING STANDARDS

COMPLIANCE AUDITING CONSIDERATIONS IN AUDITS OF GOVERNMENTAL ENTITIES AND OTHER RECIPIENTS OF GOVERNMENTAL FINANCIAL ASSISTANCE

INTRODUCTION AND APPLICABILITY

1. Compliance auditing considerations are applicable to all audits of financial statements of governmental entities and other recipients of governmental financial assistance. This Statement provides guidance for auditors who are engaged to test and report on compliance with laws and regulations in engagements under generally accepted auditing standards (GAAS), *Government Auditing Standards*, and in certain other circumstances,¹ such as single or organization-wide audits or program audits under certain federal audit regulations.² Specifically, this Statement provides guidance on the auditor's responsibility to —

- a. Apply the provisions of Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), relative to detecting misstatements resulting from illegal acts related to laws and regulations that apply to governmental financial assistance or that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental and certain nongovernmental entities.
- b. Perform an audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States.³
- c. Perform a single or organization-wide audit or a program audit in accordance with federal audit requirements.⁴
- d. Establish an understanding with management regarding the auditor's testing and reporting responsibilities when engaged to test and report on compliance with state or local laws and regulations.

¹ Guidance for engagements related to management's written assertion about either (a) an entity's compliance with requirements of specified laws, regulations, rules, contracts, or grants or (b) the effectiveness of an entity's internal control structure over compliance with specified requirements is provided in Statement on Standards for Attestation Engagements No. 3, *Compliance Attestation* (AICPA, *Codification of Statements on Auditing Standards* [Nos. 1–72], AT sec. 500).

² A single or organization-wide audit is an audit of an entity's financial statements and of compliance with federal regulations relating to federal financial assistance. Examples are audits required by the Single Audit Act of 1984 and Office of Management and Budget (OMB) Circular A-128, *Audits of State and Local Governments*, or OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. A program audit is an audit conducted in accordance with specific federal audit guides, such as the U.S. Department of Education's *Student Financial Assistance Audit Guide* (SFA Audit Guide), or the U.S. Department of Housing and Urban Development's *Consolidated Audit Guide for Audits of HUD Programs* (HUD Audit Guide).

³ In practice, *Government Auditing Standards* is sometimes referred to as *generally accepted government auditing standards* (GAGAS) or the "Yellow Book." *Government Auditing Standards* includes standards for financial and performance audits. The references to *Government Auditing Standards* in this Statement encompass only the standards for financial audits, not the performance audit standards. In July 1993, the General Accounting Office (GAO) issued an exposure draft of proposed changes to *Government Auditing Standards*.

⁴ Certain single or organization-wide audit testing and reporting responsibilities are addressed in AICPA Statements of Position (SOPs) 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance*, and 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, and are, therefore, not addressed by this Statement.

- e. Communicate with management when the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of his or her engagement.

EFFECTS OF LAWS ON FINANCIAL STATEMENTS

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

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

Such laws and regulations may deal with funds required by law, regulation, or bond covenant; procurement; debt limitations; and legal authority for transactions.

3. Federal, state, and local governmental entities provide financial assistance to other entities, including not-for-profit organizations and business enterprises that are either primary recipients or subrecipients.⁵ Among the forms of governmental financial assistance are grants of cash and other assets, loans, loan guarantees, and interest-rate subsidies.⁶ By accepting such assistance, both governmental and nongovernmental entities may be subject to laws and regulations that may have a direct and material effect on the determination of amounts in their financial statements.

4. Management is responsible for ensuring that the entity complies with the laws and regulations applicable to its activities. That responsibility encompasses identification of applicable laws and regulations and establishment of internal control policies and procedures designed to provide reasonable assurance that the entity complies with those laws and regulations. The auditor's responsibility for testing and reporting on compliance with laws and regulations varies according to the terms of the engagement.

⁵ A subrecipient is an entity that receives governmental financial assistance when the assistance is initially received by another entity (the primary recipient) that distributes the assistance for the government program that created and provided the assistance. As used in this Statement, recipient means either a primary recipient or a subrecipient.

⁶ For purposes of this Statement, *financial assistance*, as defined by the Single Audit Act of 1984 and OMB Circular A-128, does not include contracts to provide goods or services to a governmental entity or arrangements in which a nongovernmental entity purchases insurance from the government. Federal awards, as defined by OMB Circular A-133, means financial assistance and federal cost-type contracts used to buy services or goods for the use of the federal government. Federal awards do not include procurement contracts to vendors under grants or contracts used to buy goods or services. For example, financial assistance does not include a contract to design and manufacture aircraft for the U.S. Air Force or the purchase of deposit insurance by a financial institution. In addition, although Medicaid funds paid by the federal government to states constitute financial assistance, most Medicaid arrangements between the states and health-care providers are contracts for services that are not considered to be financial assistance.

COMPLIANCE AUDITING

Generally Accepted Auditing Standards

5. SAS No. 54 describes the auditor's responsibility, in an audit performed in accordance with GAAS, for considering laws and regulations and how they affect the audit.

6. Thus, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. Paragraph 5.5 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* (as of May 1, 1993) states that for general purpose financial statements "[e]xisting audit practice is that audit scope should be set and materiality evaluations should be applied at the fund type and account group level...."

Government Auditing Standards

7. *Government Auditing Standards* contains standards for audits of governmental organizations, programs, activities, and functions and for audits of governmental funds received by nonprofit organizations and other nongovernmental organizations. These standards are to be followed when required by law, regulation, agreement, contract, or policy.⁷

8. For financial audits, *Government Auditing Standards* prescribes fieldwork and reporting standards beyond those required by GAAS. The general standards of *Government Auditing Standards* relate to qualifications of the staff (including continuing education requirements), independence, due professional care, and quality control.

Federal Audit Requirements

9. Although the scope and reporting requirements of an audit of a recipient of federal financial assistance in accordance with federal audit regulations vary, the audits generally have the following elements in common:

- a. The audit is to be conducted in accordance with GAAS and *Government Auditing Standards*.
- b. The auditor's consideration of the internal control structure is to include obtaining an understanding of the accounting and administrative controls established to ensure compliance with the laws and regulations applicable to the federal financial assistance. In some instances, federal audit regulations mandate a "test of controls" to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material noncompliance.
- c. The auditor is to issue a report on the consideration of the internal control structure described above.
- d. The auditor is to determine and report on whether the federal financial assistance has been administered in accordance with applicable laws and regulations (that is, compliance requirements).

⁷ Some states have adopted regulations that require local governments within the states to have their audits conducted in accordance with *Government Auditing Standards*. In addition, some states require that recipients of state financial assistance be audited in accordance with *Government Auditing Standards*.

10. A recipient of federal financial assistance may be subject to a single or organization-wide audit or to a program audit. Some federal audit regulations permit the recipient to "elect" to have a program audit, whereas other federal audit regulations require a program audit in certain circumstances. In planning the audit, the auditor should determine and consider the specific federal audit requirements⁸ applicable to the engagement, including the issuance of additional reports. As noted in paragraph 9 of this Statement, federal audit regulations for both single or organization-wide audits and program audits require consideration of the internal control structure beyond what is normally required by GAAS and *Government Auditing Standards*, and also require a determination of whether applicable compliance requirements have been met.

11. The entity's acceptance of federal financial assistance generally includes an agreement to adhere to applicable federal laws and regulations governing the program, award, or grant. Therefore, as part of an audit of federal financial assistance, the auditor is required to test and report on whether the entity has, in all material respects, complied with the applicable federal laws or regulations (referred to as "compliance requirements").

State and Local Laws and Regulations

12. An auditor may also be required to test and report on compliance with state and local laws and regulations. The testing and reporting responsibilities of an engagement to test and report on compliance with state and local laws and regulations may differ from those addressed in this Statement. However, the guidance provided in this Statement should be applied to these engagements as applicable.

UNDERSTANDING THE EFFECTS OF LAWS AND REGULATIONS

13. The auditor should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in an entity's financial statements. The auditor should also assess whether management has identified laws and regulations that have a direct and material effect on the determination of amounts in the entity's financial statements. The auditor may consider performing the following procedures in assessing management's identification of such laws and regulations and in obtaining an understanding of their possible effects on the financial statements:

- a. Consider knowledge about such laws and regulations obtained from prior years' audits.
- b. Discuss such laws and regulations with the entity's chief financial officer, legal counsel, or grant administrators.
- c. Obtain written representation from management regarding the completeness of management's identification.
- d. Review the relevant portions of any directly related agreements, such as those related to grants and loans.

⁸ Such requirements may be set out in an engagement letter or audit contract. In some instances, a written engagement letter is required by the federal grantor agency (for example, the SFA Audit Guide; audit regulations in 7 *Code of Federal Regulations* (CFR) 1773 of the Rural Electrification Administration; and the HUD Audit Guide).

- e. Review minutes of meetings of the legislative body of the governmental entity being audited for the enactment of laws and regulations that have a direct and material effect on the determination of amounts in the governmental entity's financial statements.
- f. Inquire of the office of the federal, state, or local auditor or other appropriate audit oversight organization about laws and regulations applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.
- g. Review information about compliance requirements, such as the information included in *Compliance Supplement for Single Audits of State and Local Governments*, and *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions*, issued by the OMB (OMB's Compliance Supplements), and *Catalog of Federal Domestic Assistance*, issued by the Government Printing Office.

COMPLIANCE REQUIREMENTS APPLICABLE TO FEDERAL FINANCIAL ASSISTANCE PROGRAMS

14. Compliance requirements applicable to federal financial assistance programs are usually of two types: *general*⁹ and *specific*. General requirements are those that involve national policy and are applicable to federal financial assistance programs. General requirements for the federal programs awarded to state and local governments and to nonprofit organizations are set forth in the OMB's Compliance Supplements. Each general requirement is accompanied by suggested audit procedures to test for compliance with the requirement.

15. Specific requirements are those that are applicable to a particular federal program and generally arise from statutory requirements and regulations. The specific requirements in the OMB's Compliance Supplements are generally organized into five categories:

- a. Types of service allowed or unallowed
- b. Eligibility
- c. Matching, level of effort, and/or earmarking requirements
- d. Special reporting requirements
- e. Special tests and provisions

16. In addition to those enumerated in the OMB's Compliance Supplements, specific compliance requirements may also be enumerated in the grant agreement or contract.

17. If a program-specific audit is being performed, the auditor should consider common requirements that are statutory and regulatory requirements pertaining to certain federal programs. The common requirements are set forth in the federal grantor agency's audit guide (for example, the SFA Audit Guide). Specific requirements for program audits are enumerated in a federal grantor agency's audit guide for particular programs, in the grant agreement or contract, or in both. The OMB's Compliance Supplements and the federal grantor agency audit guides provide suggested audit procedures that may be used to test for compliance with a specific requirement.

⁹ General requirements also may be referred to as *common* requirements. (See paragraphs 17 and 18 of this Statement.)

18. Generally, the auditor is required to determine whether the recipient has complied with the general or the common and specific requirements. The form of the report and the required level of assurance to be provided in the report may vary, depending on the requirements of a particular agency or program. For example, when reporting on compliance requirements, the auditor may be required to report procedures and findings relating to compliance with those requirements or the auditor may be required to express an opinion on whether the recipient has complied with the requirements applicable to its major¹⁰ federal financial assistance programs.¹¹

EVALUATING RESULTS OF COMPLIANCE AUDIT PROCEDURES ON MAJOR FEDERAL FINANCIAL ASSISTANCE PROGRAMS

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

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

20. The criteria for classifying a cost as a questioned cost vary from one federal agency to another. In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned for each major federal financial assistance program (hereafter referred to as *likely questioned costs*), not just the questioned costs specifically identified (hereafter referred to as *known questioned costs*). When using audit sampling, as defined in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), in testing compliance, the auditor projects the amount of known questioned costs identified in the sample to the items in the major federal financial assistance program from which the sample was selected.

21. Regardless of the auditor's opinion on compliance, federal audit regulations may require him or her to report any instances of noncompliance found and any resulting questioned costs. In reporting instances of noncompliance, the auditor should follow the provisions of *Government Auditing Standards*. For purposes of reporting questioned costs, the auditor is not required to report likely questioned costs; rather, the auditor should report only known questioned costs.

22. Certain federal audit regulations recognize that, in connection with the audit of the financial statements or the consideration of the internal control structure over federal financial assistance

¹⁰ A major federal financial assistance program is defined by a federal regulation or law or by the federal grantor agency's audit guide.

¹¹ Detailed testing and reporting guidance on single or organization-wide audits and program audits is provided in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and in AICPA SOPs 92-7 and 92-9.

programs, the auditor may have selected for testing transactions from federal financial assistance programs other than major programs. If the auditor has selected such transactions, they should be tested for compliance with the requirements that apply to the individual transactions – generally, the requirements relating to the allowability of the program expenditure and the eligibility of the individuals or groups to which the entity provides federal financial assistance. For example, if in the audit of the financial statements an auditor examines a payroll transaction that was charged to a nonmajor program, the auditor should determine whether the position could reasonably be charged to that program and whether the individual’s salary was correctly charged to that program.

TYPE OF AUDIT ENGAGEMENT

23. Management is responsible for obtaining audits that satisfy relevant legal, regulatory, or contractual requirements. Auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. When a proposal, contract, or engagement letter is used, an auditor may consider including in it a statement about the type of engagement and whether the engagement is intended to meet specific audit requirements.

24. Generally accepted auditing standards do not require the auditor to perform procedures beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. Therefore, if during a GAAS audit of the financial statements the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.¹² For example, the auditor will be required to make this communication if an entity engages an auditor to perform an audit of its financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement the entity also is required to have an audit performed in accordance with one or more of the following:

- a. *Government Auditing Standards*
- b. The Single Audit Act of 1984 and OMB Circular A-128, *Audits of State and Local Governments*
- c. OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*
- d. Other compliance audit requirements, such as state or local laws or program audits under federal audit guides

25. The communication required by paragraph 24 of this Statement may be oral or written. If the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client’s actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor’s report on those financial statements. Specifically, the auditor should consider

¹² For entities that do not have an audit committee, "others with equivalent authority or responsibility" may include the board of directors, the board of trustees, the owner in owner-managed entities, the city council, or the legislative standing committee.

management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54.

EFFECTIVE DATE

26. The provisions of this Statement are effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. Early application of this Statement is encouraged.