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Proposed statement on auditing standards: compliance audits; Exposure draft (American Institute of Certified Public Accountants), 2008, December 24

American Institute of Certified Public Accountants. Auditing Standards Board

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EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

COMPLIANCE AUDITS

(To supersede Statement on Auditing Standards No. 74, Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance [AICPA, Professional Standards, vol. 1, AU sec. 801])

December 24, 2008

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues.

Comments should be sent via the Internet to Sharon Macey at smacey@aicpa.org or Audit and Attest Standards, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 and should be received by April 30, 2009.

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December 24, 2008

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board (ASB), of a proposed Statement on Auditing Standards (SAS) entitled *Compliance Audits*.

The proposed SAS would supersede SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801).

Comments or suggestions on any aspect of this exposure draft would be appreciated. To facilitate the ASB's consideration of responses, comments should refer to specific paragraphs and include supporting reasons for each suggestion or comment.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after June 1, 2009, for one year. Responses should be sent to Sharon Macey at smacey@aicpa.org or Audit and Attest Standards, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 in time to be received by April 30, 2009.

Sincerely,

Harold L. Monk, Jr.



Chair, Auditing Standards Board

Charles E. Landes



Vice President, Professional Standards and Services

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Summary

Why the Proposed SAS Is Being Issued

Governments frequently establish governmental audit requirements for entities to undergo an audit of their compliance with applicable compliance requirements. Compliance requirements are laws, regulations, rules, and provisions of contracts or grant agreements with which an entity is required to comply. *Applicable* compliance requirements are the compliance requirements that are subject to the compliance audit. The Auditing Standards Board has developed this proposed Statement on Auditing Standards (SAS), *Compliance Audits*, to update and clarify requirements and provide guidance to auditors auditing and reporting on an entity's compliance with applicable compliance requirements.

In June 2007, the President's Council on Integrity and Efficiency (PCIE) issued a report to the Office of Management and Budget (OMB) entitled *Report on National Single Audit Sampling Project* containing the findings of a federal study of the quality of audits performed under OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. The report recommends that the OMB work with the AICPA, the PCIE, the Executive Council on Integrity and Efficiency, and other parties, as appropriate, to address the deficiencies and other matters identified in the report and implement the report's recommendations. A number of AICPA task forces have been working to address various recommendations in the report. This exposure draft addresses certain recommendations related to generally accepted auditing standards (GAAS) for auditors performing compliance audits. (The PCIE report is available at www.ignet.gov/pande/audit/NatSamProjRptFINAL2.pdf.)

What the Proposed SAS Does

The proposed SAS would supersede SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), and would revise AU section 801 by

- changing the title of the standard.
- clarifying its applicability.
- updating it for changes in the compliance audit environment.
- establishing a requirement for the auditor to adapt and apply GAAS, including the risk assessment and fraud standards (all of which primarily address audits of financial statements), to a compliance audit and providing guidance on how to do so.
- identifying the AU sections that are applicable to a compliance audit and those that are not applicable.
- defining terms related to a compliance audit.
- identifying auditor requirements that are unique to a compliance audit.
- providing guidance on the factors an auditor may consider in evaluating whether an entity has materially complied with the applicable compliance requirements.
- identifying the elements to be included in an auditor's report on compliance.

How the Proposed SAS Affects Existing Standards

This proposed SAS would supersede SAS No. 74.

Proposed Statement on Auditing Standards, *Compliance Audits*

Introduction and Applicability

1. Governments frequently establish governmental audit requirements for entities to undergo an audit of their compliance with applicable compliance requirements. This Statement on Auditing Standards (SAS) is applicable when an auditor is engaged to perform a compliance audit in accordance with all of the following:

- Generally accepted auditing standards (GAAS)
- The standards for financial audits under *Government Auditing Standards*¹ (GAGAS or the Yellow Book)
- A governmental audit requirement

2. This SAS addresses the application of GAAS to a compliance audit. Compliance audits usually are performed in conjunction with a financial statement audit. This SAS does not apply to the financial statement audit component of such engagements. Although certain AU sections are not applicable to a compliance audit, as indicated in exhibit A of this SAS, all AU sections are applicable to the audit of financial statements performed in conjunction with a compliance audit.

3. This SAS is not applicable when the governmental audit requirement calls for an examination, in accordance with Statements on Standards for Attestation Engagements, of an entity's compliance with specified requirements or an examination of an entity's internal control over compliance. AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1), is applicable to these engagements. If the entity is required to undergo a compliance audit and an examination of internal control over compliance, this SAS is applicable to performing and reporting on the compliance audit and AT section 601 is applicable to performing and reporting on the examination of internal control over compliance.

4. AU sections 100–700 and 900 address audits of financial statements, as well as other kinds of engagements (for example, reports on the application of accounting principles under AU section 625, *Reports on the Application of Accounting Principles* [AICPA, *Professional Standards*, vol. 1], and reviews of interim financial information under AU section 722, *Interim Financial Information* [AICPA, *Professional Standards*, vol. 1]). AU sections 100–300 and 500 generally can be adapted to the objectives of a compliance audit. However, with certain exceptions, AU sections 400, 600, 700, and 900 generally cannot be adapted to a compliance audit because they address the auditor's report on an audit of financial statements and other topics that are not applicable to a compliance audit.

5. The AU sections that are not applicable to a compliance audit are listed in exhibit A of this SAS. All of the other AU sections are applicable to a compliance audit. However, it is not the auditor's objective to make a literal translation of each procedure that might be performed in a financial statement audit to a compliance audit, but rather to obtain sufficient appropriate audit evidence to support the auditor's opinion on compliance.

6. Some AU sections are relatively easy to adapt and apply to a compliance audit, for example, by simply replacing the word *misstatement* with the word *noncompliance*. Other AU sections are more difficult to

¹ The professional standards and guidance contained in *Government Auditing Standards* are commonly referred to as generally accepted government auditing standards (GAGAS). In this Statement on Auditing Standards, the acronym GAGAS is used to represent *Government Auditing Standards*.

adapt and apply and entail additional modification. For that reason, this SAS provides more specific guidance on how to adapt and apply certain AU sections to a compliance audit.

7. GAGAS and governmental audit requirements contain certain standards and requirements that are supplementary to those in GAAS, as well as guidance on how to apply those standards and requirements.

Management's Responsibilities

8. A compliance audit is based on the premise that management is responsible for the entity's compliance with compliance requirements. Management's responsibility for the entity's compliance with compliance requirements includes the following:

- a. Identifying the entity's government programs, and understanding and complying with the compliance requirements
- b. Establishing and maintaining controls that provide reasonable assurance that the entity manages government programs in compliance with the compliance requirements
- c. Evaluating and monitoring the entity's compliance with the compliance requirements
- d. Taking corrective action on audit findings of the compliance audit

Effective Date

9. The provisions of this SAS are effective for compliance audits for fiscal periods ending on or after June 15, 2010. Earlier application is permitted.

Objectives (Ref: par. A1)

10. The objectives of the auditor in a compliance audit are the following:

- a. Obtain sufficient appropriate audit evidence to form an opinion and report at the level specified in the governmental audit requirement on whether the entity complied in all material respects with the applicable compliance requirements
- b. Meet the supplementary audit requirements of the governmental audit requirement, if any

Definitions

11. For the purpose of adapting GAAS to a compliance audit, the following terms have the meanings attributed as follows:

Applicable compliance requirements. Compliance requirements that are subject to the compliance audit.

Audit findings. The matters that are required to be reported by the auditor in accordance with the governmental audit requirement.

Audit risk of noncompliance. The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on the entity's compliance when material noncompliance exists. Audit risk of

noncompliance consists of inherent risk of noncompliance, control risk of noncompliance, and detection risk of noncompliance.

Compliance audit. A program-specific audit or an organization-wide audit of an entity's compliance with applicable compliance requirements.

Compliance requirements. Laws, regulations, rules, and provisions of contracts or grant agreements applicable to government programs with which the entity is required to comply.

Control risk of noncompliance. The risk that material noncompliance will not be prevented or detected and corrected on a timely basis by the entity's internal control over compliance.

Deficiency in internal control over compliance. A deficiency in the design or operation of a control over compliance that does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct noncompliance on a timely basis.

A deficiency in *design* exists when a control necessary to meet the control objective is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

A deficiency in *operation* exists when a properly designed control does not operate as designed or the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Detection risk of noncompliance. The risk that the auditor will not detect material noncompliance. Detection risk of noncompliance is a function of the effectiveness of the audit procedures and their application by the auditor.

Governmental audit requirement. A government requirement established by law, regulation, rule, or provision of contracts or grant agreements requiring that an entity undergo an audit of its compliance with applicable compliance requirements related to one or more government programs that the entity administers. Such audit requirements also may set forth specific supplementary requirements of the audit (for example, procedures to be performed by the auditor, documentation requirements, the form of reporting, and continuing professional education requirements with which the auditor is required to comply).

Government Auditing Standards. Standards and guidance issued by the Comptroller General of the United States, U.S. Government Accountability Office for financial audits, attestation engagements, and performance audits. *Government Auditing Standards* also are known as GAGAS or the Yellow Book.

Government program. The means by which governmental entities achieve their objectives. For example, one of the objectives of the U.S. Department of Agriculture is to provide nutrition to individuals in need. Examples of government programs designed to achieve that objective are the Supplemental Nutrition Assistance Program and the National School Lunch Program. Government programs that are relevant to this SAS are those in which a grantor or pass-through entity provides an award to another entity, usually in the form of a grant, contract, or other agreement. Not all government programs provide cash assistance; sometimes noncash assistance is provided (for example, a loan guarantee).

Grantor. A government agency from which funding for the government program originates.

Inherent risk of noncompliance. The susceptibility of an applicable compliance requirement to material noncompliance, assuming there are no related controls.

Known questioned costs. Questioned costs specifically identified by the auditor. Known questioned costs are a subset of likely questioned costs.

Likely questioned costs. The best estimate of total questioned costs, not just the known questioned costs. The auditor's best estimate of likely questioned costs is developed by extrapolating from audit evidence obtained, for example, by projecting known questioned costs identified in an audit sample to the entire population from which the sample was drawn.

Material noncompliance. A failure to follow requirements or a violation of prohibitions included in the applicable compliance requirements that results in noncompliance that is quantitatively or qualitatively significant, either individually or when aggregated with other noncompliance, to the affected government program. Governmental audit requirements may provide an alternative definition of material noncompliance.

Material weakness in internal control over compliance. A deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented or detected and corrected on a timely basis. In this SAS, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable* as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*.

Organization-wide audit. An audit of an entity's financial statements and an audit of its compliance with the applicable compliance requirements as they relate to one or more government programs that the entity administers.

Pass-through entity. An entity that receives an award from a grantor or other entity and distributes all or part of it to another entity to administer a government program.

Program-specific audit. An audit of an entity's compliance with applicable compliance requirements as they relate to one government program that the entity administers. In addition to the compliance audit, a program-specific audit includes either an audit of the entity's or the program's financial statements.

Questioned costs. Costs that are questioned by the auditor because (1) of a violation or possible violation of the applicable compliance requirements, (2) the costs are not supported by adequate documentation, or (3) the incurred costs appear unreasonable and do not reflect the actions that a prudent person would take in the circumstances.

Risk of material noncompliance. The combined assessment of inherent risk and control risk of noncompliance.

Significant deficiency in internal control over compliance. A deficiency, or a combination of deficiencies, in internal control over compliance that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Requirements

Adapting and Applying the AU Sections to a Compliance Audit (Ref: par. A2)

12. When performing a compliance audit, the auditor, using professional judgment, should adapt and apply the AU sections to the objectives of a compliance audit, except for the AU sections listed in exhibit A of this SAS.

Establishing Materiality Levels (Ref: par. A3–A5)

13. The auditor should establish materiality levels for the audit based on the governmental audit requirement.

Performing Risk Assessment Procedures

14. As discussed in paragraph 8, management is responsible for identifying the entity's government programs and understanding and complying with the compliance requirements. The auditor should determine which of those government programs and compliance requirements to test in accordance with the governmental audit requirement.

15. The auditor should perform risk assessment procedures to obtain a sufficient understanding of the government program, the applicable compliance requirements, and internal control over compliance with the applicable compliance requirements.² (Ref: par. A6–A11)

16. In performing risk assessment procedures, the auditor should query management about whether there are findings and recommendations in reports or other written communications resulting from previous audits, attestation engagements, and internal or external monitoring that directly relate to the objectives of the compliance audit. The auditor should gain an understanding of management's response to findings and recommendations that could have a material effect on the entity's compliance with the applicable compliance requirements (for example, taking corrective action). The auditor should use this information to assess risk and determine the nature, timing, and extent of the audit procedures for the audit, including determining the extent to which testing the implementation of any corrective actions is applicable to the audit objectives. (Ref: par. A12)

Assessing the Risks of Material Noncompliance (Ref: par. A13–A14)

17. The auditor should assess the risks of material noncompliance whether due to error or fraud for each applicable compliance requirement.³

Performing Further Audit Procedures in Response to Assessed Risks

18. If the auditor identifies a risk of material noncompliance that is pervasive to the entity's compliance, the auditor should develop an overall response to the assessed risks of material noncompliance. (Ref: par. A15)

19. The auditor should design and perform further audit procedures, including tests of details, to obtain sufficient appropriate audit evidence about the entity's compliance with each of the applicable compliance requirements in response to the assessed risks of material noncompliance. (Ref: par. A16–A17)

20. The auditor should adapt and apply the requirements and refer to the guidance in paragraphs .07–.39 and .46–.67 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), in designing and performing further audit procedures in response to the assessed risks of material noncompliance. These procedures should include performing tests of controls over compliance if

- the auditor's risk assessment includes an expectation of the operating effectiveness of controls over compliance related to the applicable compliance requirements,
- substantive procedures alone do not provide sufficient appropriate audit evidence, or

² See paragraphs .01–.08, .10–.43, .46–.82, and .87–.101 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1).

³ See paragraphs .103–.121 of AU section 314.

- such tests of controls over compliance are required by the governmental audit requirement.

If any of the conditions in this paragraph are met, the auditor should test the operating effectiveness of controls over each applicable compliance requirement to which the conditions apply in each compliance audit. (Ref: par. A18)

Supplementary Audit Requirements (Ref: par. A19)

21. The auditor should identify audit requirements specified in the governmental audit requirement that are supplementary to GAAS and GAGAS and perform procedures to address those requirements.

22. In instances where audit guidance provided by a governmental agency for the performance of compliance audits has not been updated for, or otherwise conflicts with, current GAAS or GAGAS, the auditor should comply with the most current applicable GAAS and GAGAS instead of the outdated or conflicting guidance.

Written Representations (Ref: par. A20)

23. The auditor should obtain written representations from management related to the entity's compliance with the applicable compliance requirements. The auditor should determine that the matters addressed by the representations and the content of the representations have been tailored to the entity, the governmental audit requirement, and the applicable compliance requirements.⁴

Subsequent Events

24. The auditor should consider information about subsequent events that comes to his or her attention after the end of the period addressed by the auditor's report and prior to the issuance of his or her report. Paragraphs 25 and 26 of this SAS identify the two types of subsequent events that may occur and the auditor's responsibility for them. The first type consists of events that provide additional information about the entity's compliance during the audit period that may affect the auditor's report. The second type consists of events that provide evidence of noncompliance that occurs subsequent to the audit period but before the date of the auditor's report.

25. For the period from the end of the reporting period to the date of the auditor's report, the auditor should perform procedures to identify events that provide additional information about the entity's compliance during the period covered by the auditor's report that may affect the auditor's report. Such procedures should include, but are not limited to, inquiring about and considering the following information:

- Management's knowledge regarding whether any subsequent events have occurred that might affect the auditor's report on compliance
- Relevant internal auditors' reports issued during the subsequent period
- Other auditors' reports identifying noncompliance that were issued during the subsequent period
- Regulatory agencies' reports on the entity's noncompliance that were issued during the subsequent period

⁴ See AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1).

- Information about the entity's noncompliance obtained through other professional engagements performed by the auditor for that entity

26. The auditor has no responsibility to detect noncompliance that occurs subsequent to the period being reported on. However, if before the date of the auditor's report, the auditor becomes aware of such noncompliance that is of such a nature and significance that its disclosure is needed to prevent report users from being misled, the auditor should include an explanatory paragraph in his or her report describing the nature of the noncompliance. (Ref: par. A21)

Forming an Opinion and Reporting (Ref: par. A22–A25)

27. The auditor should evaluate the sufficiency and appropriateness of the audit evidence obtained.⁵ (Ref: par. A22–A23)

28. The auditor should form an opinion, at the level specified by the governmental audit requirement, on whether the entity complied in all material respects with the applicable compliance requirements, and report appropriately. In forming an opinion, the auditor should evaluate likely questioned costs, not just known questioned costs, as well as other material noncompliance that, by its nature, may not result in questioned costs. (Ref: par. A22–A23)

29. The auditor should report noncompliance as well as other matters that are required to be reported by the governmental audit requirement in the manner specified by the governmental audit requirement.

30. The auditor's report on compliance should include the following elements:

- a. A title that includes the word *independent*
- b. Identification of the one or more government programs covered by the audit or reference to a separate schedule containing that information
- c. Identification of the applicable compliance requirements or a reference to where they can be found
- d. Identification of the period covered by the report
- e. A statement that compliance with the applicable compliance requirements is the responsibility of the entity's management
- f. A statement that the auditor's responsibility is to express an opinion on the entity's compliance with the applicable compliance requirements based on the audit
- g. A statement that the audit was conducted in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and the governmental audit requirement
- h. A statement that the audit included examining, on a test basis, evidence about the entity's compliance with those requirements and performing such other procedures as the auditor considered necessary in the circumstances
- i. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion
- j. A statement that the audit does not provide a legal determination of the entity's compliance

⁵ See paragraphs .70–.76 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1).

- k. The auditor's opinion, at the level specified by the governmental audit requirement, on whether the entity complied, in all material respects, with the applicable compliance requirements
- l. If noncompliance is identified that results in an opinion modification, a description of such noncompliance or a reference to a description of such noncompliance in an accompanying schedule
- m. If other noncompliance that is required to be reported by the governmental audit requirement is identified (that is, noncompliance that does not result in an opinion modification), a description of such noncompliance or a reference to a description of such noncompliance in an accompanying schedule
- n. If the criteria used to evaluate compliance are
 - (1) established or determined by contractual agreement or regulatory provisions that are developed solely for the parties to the agreement or regulatory agency responsible for the provisions or
 - (2) available only to the specified parties,

a separate paragraph at the end of the report stating that the report is intended solely for the information and use of [*identify the body or individuals charged with governance*], others within the entity, [*identify the legislative or regulatory body*], grantors, and, if applicable, pass-through entities and is not intended to be and should not be used by anyone other than these specified parties (Ref: par. A24)

- o. The manual or printed signature of the auditor's firm
- p. The date of the auditor's report

31. When the auditor combines the auditor's report on compliance with a report on internal control over compliance, the following should be added to the report elements listed in paragraph 30:

- a. A statement that management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, rules, and provisions of contracts or grant agreements applicable to government programs.
- b. A statement that in planning and performing the audit, the auditor considered the entity's internal control over compliance with the applicable compliance requirements to determine the auditing procedures for the purpose of expressing an opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance.
- c. A statement that the auditor is not expressing an opinion on internal control over compliance.
- d. A statement that the auditor's consideration of the entity's internal control over compliance was not designed to identify all significant deficiencies or material weaknesses in internal control over compliance, and, therefore, all significant deficiencies or material weaknesses in internal control over compliance may not have been identified.
- e. The definition of *deficiency in internal control over compliance* and *material weakness in internal control over compliance*.
- f. A description of any identified material weaknesses in internal control over compliance or a reference to an accompanying schedule containing such a description.

- g. If significant deficiencies in internal control over compliance were identified, the definition of *significant deficiency in internal control over compliance* and a description of the deficiencies or a reference to an accompanying schedule containing such a description.
- h. If no material weaknesses in internal control over compliance were identified, a statement to that effect.
- i. The restricted use paragraph described in paragraph 30*n*. The restricted use paragraph should be included in all combined reports on the entity's compliance and internal control over compliance.

32. If the governmental audit requirement requires the auditor to report on internal control over compliance and the auditor chooses to issue a separate report on internal control over compliance, the auditor should include in that separate report the elements in paragraph 31 and the following additional elements:

- a. A title that includes the word *independent*
- b. A statement that the auditor audited the entity's compliance with applicable compliance requirements pertaining to [*identify the government program(s) and the period audited*] and a reference to the auditor's report on compliance
- c. A statement that the audit was conducted in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and the governmental audit requirement
- d. The manual or printed signature of the auditor's firm
- e. The date of the report

33. The auditor should modify the report described in paragraphs 30 and 31 if any of the following conditions exist:

- a. A restriction on the scope of the audit
- b. The auditor is making reference to the report of another auditor as the basis, in part, for the auditor's report
- c. The auditor is unable to comply with GAAS, GAGAS, or the governmental audit requirement

34. The auditor should communicate in writing to management and those charged with governance identified significant deficiencies and material weakness in internal control over compliance.⁶ (Ref: par. A25)

35. The auditor also should communicate to those charged with governance of the entity the matters addressed by AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1).

36. Printed forms, schedules, or reports designed or adopted by government agencies with which they are to be filed sometimes contain prescribed wording. If a printed form, schedule, or report requires the auditor to make a statement that he or she has no basis to make, the auditor should reword the form, schedule, or report accordingly or attach an appropriately worded separate report.

⁶ See AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1).

Documentation (Ref: par. A26)

37. The auditor should document the risk assessment procedures performed, including those related to gaining an understanding of internal control over compliance.⁷

38. The auditor should document his or her response to assessed risk of material noncompliance, the procedures performed to test compliance with the applicable compliance requirements, and the results of those procedures, including any tests of controls over compliance.⁸

39. The auditor should document materiality levels and how they were determined.

40. The auditor should document how he or she complied with the specific governmental audit requirements that are supplementary to GAAS and GAGAS.

Reissuance of the Compliance Report (Ref: par. A27)

41. If an auditor is required to reissue his or her compliance report, the reissued report should include an explanatory paragraph stating that the report is replacing a previously issued report and describing the reasons why the report is being reissued, and any changes from the previously issued report. If all of the government programs being reported on are affected by the circumstances requiring the reissuance, the auditor's report date should be updated to reflect the new procedures. If, however, only some of the government programs being reported on are affected by the circumstances requiring the reissuance, the auditor should dual date the report with the updated report date referencing the government programs for which additional audit procedures have been performed.

Application Guidance and Explanatory Material

Objectives (Ref: par. 10)

A1. Most governmental audit requirements specify that the auditor's opinion on compliance is at the program level. However, some governmental audit requirements may specify a different level (for example, at the applicable compliance requirement level).

Adapting and Applying the AU Sections to a Compliance Audit (Ref: par. 12)

A2. AU sections often identify audit procedures and contain examples that are specific to a financial statement audit. The auditor is not expected to adapt or apply all such procedures to the compliance audit, only those that, in the auditor's professional judgment, are relevant and necessary to meet the objectives of the compliance audit.

Establishing Materiality Levels (Ref: par. 13)

A3. In a compliance audit, the auditor's purpose for establishing materiality levels is to

- a. determine the nature and extent of risk assessment procedures.

⁷ See paragraphs .122 –.123 of AU section 314.

⁸ See paragraph .77 of AU section 318.

- b. identify and assess the risks of material noncompliance.
- c. determine the nature, timing, and extent of further audit procedures.
- d. evaluate whether the entity complied with the applicable compliance requirements.
- e. report findings of noncompliance and other matters required to be reported by the governmental audit requirement.

A4. Generally, for all of the purposes identified in paragraph A3, the auditor's consideration of materiality is in relation to the government program taken as a whole. However, the governmental audit requirement may specify a different level of materiality for one or more of these purposes. For example, for purposes of reporting findings of noncompliance, Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*, requires that noncompliance that is material in relation to one of the 14 types of compliance requirements identified in the OMB Compliance Supplement (Compliance Supplement) be reported. (See paragraph A7 for further information about the Compliance Supplement)

A5. Because the governmental audit requirement usually is established by the grantors and the auditor's report on compliance is primarily for their use, the auditor's determination of materiality usually is influenced by the needs of the grantors. However, in a compliance audit, the auditor's judgment about matters that are material to users of the auditor's report also is based on consideration of the needs of users as a group, including grantors.

Performing Risk Assessment Procedures (Ref: par. 14–16)

A6. Some governmental audit requirements specifically identify the applicable compliance requirements. Other governmental audit requirements provide a framework for the auditor to determine the applicable compliance requirements. For example, the Compliance Supplement provides such a framework for A-133 audits. (Ref: par.14)

A7. The following are some of the sources an auditor may consult when identifying and obtaining an understanding of the applicable compliance requirements:

- a. The Compliance Supplement, which is used in OMB Circular A-133 audits, contains the compliance requirements that typically are applicable to federal government programs, as well as suggested audit procedures when compliance requirements are applicable and have a direct and material effect on the entity's compliance. Part 7 of the Compliance Supplement provides guidance for identifying compliance requirements for programs not included therein.
- b. The applicable program-specific audit guide, which contains the compliance requirements pertaining to the government program and suggested audit procedures to test for compliance with the applicable compliance requirements. (Ref: par. 14)

A8. The following are procedures the auditor may perform to identify and obtain an understanding of the applicable compliance requirements if a Compliance Supplement or a program-specific audit guide is not available:

- a. Inquiry of management and other knowledgeable entity personnel (for example, the chief financial officer, internal auditors, legal counsel, compliance officers, or grant or contract administrators).
- b. Inquiry of appropriate individuals outside the entity, such as

- (1) the office of the federal, state, or local program official or auditor, or other appropriate audit oversight organizations or regulators, about the laws and regulations applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.
 - (2) a third-party specialist, such as an attorney.
- c. Reading laws, regulations, rules, and provisions of contracts or grant agreements that pertain to the government program.
 - d. Reading the minutes of meetings of the governing board of the entity being audited.
 - e. Reading audit documentation about the applicable compliance requirements prepared during prior years' audits or other engagements.
 - f. Discussing the applicable compliance requirements with auditors who performed prior years' audits or other engagements.

The procedures listed in this paragraph also may assist the auditor in obtaining a further understanding of the applicable compliance requirements even when a Compliance Supplement or program-specific audit guide is available. (Ref: par. 14)

A9. Obtaining an understanding of the government program and the entity's environment establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing risks of material noncompliance and responding to those risks throughout the audit. (Ref: par. 15)

A10. The nature and extent of the risk assessment procedures the auditor performs may vary from entity to entity and are influenced by factors such as the following:

- The newness and complexity of the applicable compliance requirements
- The auditor's knowledge of the entity's internal control over compliance with the applicable compliance requirements obtained in previous audits or other professional engagements
- The nature of the applicable compliance requirements
- The services provided by the entity and how they are affected by external factors
- The level of oversight by the grantor or pass-through entity
- How management addresses findings (Ref: par. 15)

A11. Performing risk assessment procedures includes obtaining an understanding of the entity's internal control over compliance. Internal control consists of the following five interrelated components: the control environment, the entity's risk assessment, information and communication systems, control activities, and monitoring.⁹ Paragraphs .67–.82, .87–.101, and appendix B of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), contain a detailed discussion of these components. (Ref: par. 15)

A12. The auditor's procedures related to understanding how management has responded to findings and recommendations that directly relate to the objectives of a compliance audit and were identified in previous audits, attestation engagements, or other forms of monitoring are performed to assist the auditor in understanding whether management responded appropriately to such findings. Examples of external monitoring include regulatory reviews, program reviews by government agencies or pass-

⁹ See paragraph .41 of AU section 314.

through entities, and grantor reviews. Examples of internal monitoring include reports prepared by the internal audit function and internal quality assessments. (Ref: par. 16)

Assessing the Risks of Material Noncompliance (Ref: par. 17)

A13. Factors the auditor may consider in assessing inherent risk of noncompliance are the following:

- The complexity of the applicable compliance requirements
- The susceptibility of the applicable compliance requirements to noncompliance
- The length of time the entity has been subject to the applicable compliance requirements
- The auditor's prior experience with the entity's compliance with the applicable compliance requirements
- The potential effect on the entity of noncompliance with the applicable compliance requirements

A14. In assessing the risks of material noncompliance, the auditor may evaluate inherent risk of noncompliance and control risk of noncompliance individually or in combination.

Performing Further Audit Procedures in Response to Assessed Risks (Ref: par. 18–20)

A15. Examples of situations in which there is a risk of material noncompliance that is pervasive to the entity's noncompliance are as follows:

- An entity that is experiencing financial difficulty and for which there is an increased risk that grant funds will be diverted for unauthorized purposes
- An entity that has a history of poor record keeping for its government programs

Paragraphs .04–.06 of AU section 318 provide guidance that may be adapted when developing an overall response to the risks of material noncompliance. (Ref: par. 18)

A16. A compliance audit includes designing procedures to detect both intentional and unintentional material noncompliance. The auditor can attain reasonable, but not absolute, assurance about the entity's compliance because of factors such as the need for judgment, the use of sampling, the inherent limitations of internal control over compliance with applicable compliance requirements, and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. Also, procedures that are effective for detecting noncompliance that is unintentional may be ineffective for detecting noncompliance that is intentional and concealed through collusion between entity personnel and a third party or among management or employees of the entity. Therefore, the subsequent discovery that material noncompliance with applicable compliance requirements exists does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor. (Ref: par. 19)

A17. The use of analytical procedures to gather substantive evidence is less effective in a compliance audit than it is in a financial statement audit. However, substantive analytical procedures may contribute some evidence when performed in addition to tests of transactions and other auditing procedures necessary to provide the auditor with sufficient appropriate audit evidence. (Ref: par. 19)

A18. Some governmental audit requirements require tests of the operating effectiveness of controls identified as likely to be effective, even if the auditor believes that such testing would be inefficient. (Ref: par. 20)

Supplementary Audit Requirements (Ref: par. 21)

A19. Examples of supplementary audit requirements are the requirements in OMB Circular A-133 for the auditor to

- perform specified procedures to identify major programs.
- follow up on prior audit findings and perform procedures to assess the reasonableness of the summary schedule of prior audit findings.

Written Representations (Ref: par. 23)

A20. The specific written representations the auditor requests of management will depend on the governmental audit requirement. Examples of representations the auditor may request from management include representations

- a. acknowledging management's responsibility for understanding and complying with the compliance requirements.
- b. acknowledging management's responsibility for establishing and maintaining controls that provide reasonable assurance that the entity manages government programs in compliance with the compliance requirements.
- c. stating that management has identified all of its government programs and related activities subject to the governmental audit requirement.
- d. stating that management has made available all contracts and grant agreements, including amendments, if any, and any other correspondence relevant to the programs subject to the governmental audit requirement.
- e. stating that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements or stating that there was no such noncompliance.
- f. stating that management has made available to the auditor all documentation related to compliance with the applicable compliance requirements.
- g. identifying management's interpretation of any applicable compliance requirements that are subject to varying interpretations.
- h. stating that management has disclosed to the auditor any communications from regulatory agencies concerning possible noncompliance with the applicable compliance requirements, including communications received from the end of the period covered by the audit to the date of the auditor's report.
- i. stating that management has disclosed to the auditor the findings received and related corrective actions taken for previous audits, attestation engagements, internal or external monitoring, and any other studies that directly relate to the objectives of the compliance audit, including findings received and corrective actions taken from the end of the period covered by the audit to the date of the auditor's report.
- j. stating that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements subsequent to the period covered by the auditor's report or stating that there were no such known instances.

- k. stating that management is responsible for taking corrective action on audit findings of the compliance audit.

Subsequent Events (Ref: par. 26)

A21. An example of a matter of noncompliance that may occur subsequent to the period being audited but before the report is issued and that may warrant disclosure to prevent report users from being misled is the discovery of noncompliance in the subsequent period of such magnitude that it caused the grantor to stop funding the program.

Forming an Opinion and Reporting

A22. The following are factors the auditor may consider in evaluating whether an entity has materially complied with the applicable compliance requirements:

- a. The frequency of noncompliance with the applicable compliance requirements identified during the audit
- b. The nature of the noncompliance with the applicable compliance requirements identified
- c. The adequacy of the entity's system for monitoring compliance with the applicable compliance requirements and the possible effect of any noncompliance on the entity
- d. Whether any identified noncompliance with the applicable compliance requirements resulted in likely questioned costs that are material to the government program (Ref: par. 27–28)

A23. The auditor's evaluation of whether the entity materially complied with applicable compliance requirements includes consideration of noncompliance identified by the auditor, regardless of whether the entity corrected the noncompliance after the auditor brought it to management's attention. (Ref: par. 27–28)

A24. Nothing precludes the auditor from restricting the use of any report.¹⁰ (Ref: par. 30n)

A25. Management may wish to, or be required by a regulator to, prepare a written response to the auditor's communication regarding significant deficiencies or material weaknesses in internal control over compliance identified during the audit. If such a written response is included in a document containing the auditor's written communication to management and those charged with governance concerning identified significant deficiencies or material weaknesses in internal control over compliance, the auditor may add a paragraph to his or her written communication disclaiming an opinion on such information. Following is an example of such a paragraph:

ABC Agency's written response to the significant deficiencies [*and material weaknesses*] in internal control over compliance identified in our audit was not subjected to the auditing procedures applied in the audit of ABC Agency's compliance and, accordingly, we express no opinion on it. (Ref: par. 34)

Documentation (Ref: par. 37–40)

A26. The auditor is not expected to prepare specific documentation of how the auditor adapted and applied each of the applicable AU sections to the objectives of a compliance audit. The documentation of

¹⁰ Footnote 4 of AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1).

the audit strategy, audit plan, and work performed cumulatively demonstrate whether the auditor has complied with the requirement in paragraph 12.

Reissuance of the Compliance Report (Ref: par. 41)

A27. The following are examples of situations in which the auditor might be required to reissue the compliance report:

- A quality control review performed by a governmental agency indicates that the auditor did not test an applicable compliance requirement
- The discovery subsequent to the date of the compliance report that the entity had another government program that should have been tested

A28.

Exhibit A

AU Sections That Are Not Applicable to Compliance Audits

The following sections of AICPA *Professional Standards* are not applicable to a compliance audit performed under AU section 801, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1), either because (1) they are not relevant to a compliance audit environment, (2) the procedures and guidance would not contribute to meeting the objectives of a compliance audit, or (3) the subject matter is specifically covered in AU section 801. However, nothing precludes an auditor from applying these sections if the auditor believes they will provide appropriate audit evidence in the specific circumstances to support the auditor's opinion on compliance.

| AU Sections in AICPA <i>Professional Standards</i> That Do Not Apply to Compliance Audits |
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| Paragraph .01 of AU section 110, <i>Responsibilities and Functions of the Independent Auditor</i> |
| Standards of reporting in paragraph .02 of AU section 150, <i>Generally Accepted Auditing Standards</i> |
| Paragraphs .09, .44–.45, .83–.86, and .102 of AU section 314, <i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</i> |
| Paragraphs .12–.13 and .21–.22 of AU section 315, <i>Communications Between Predecessor and Successor Auditors</i> |
| The bullet in paragraph .50 about accounting principles in AU section 316, <i>Consideration of Fraud in a Financial Statement Audit</i> |
| AU section 317, <i>Illegal Acts by Clients</i> |
| Paragraphs .52, .68–.69, and the appendix of AU section 318, <i>Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</i> |
| Paragraphs .22–.60 of AU section 324, <i>Service Organizations</i> |
| Paragraphs .14–.19 of AU section 326, <i>Audit Evidence</i> |
| AU section 328, <i>Auditing Fair Value Measurements and Disclosures</i> |
| AU section 330, <i>The Confirmation Process</i> , except for paragraphs .31–.32, which address alternative procedures |
| AU section 331, <i>Inventories</i> |
| AU section 332, <i>Auditing Derivative Instruments, Hedging Activities, and Investments in Securities</i> |
| Paragraph .12 of AU section 333, <i>Management Representations</i> |
| AU section 334, <i>Related Parties</i> |
| AU section 337, <i>Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments</i> |
| AU section 341, <i>The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern</i> |
| AU section 342, <i>Auditing Accounting Estimates</i> |
| AU section 410, <i>Adherence to Generally Accepted Accounting Principles</i> |
| AU section 411, <i>The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles</i> |
| AU section 420, <i>Consistency of Application of Generally Accepted Accounting Principles</i> |

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| AU section 431, <i>Adequacy of Disclosure in Financial Statements</i> |
| AU section 504, <i>Association With Financial Statements</i> |
| Paragraphs .05, .09, .11 <i>b–h</i> , .14–.18, .27–.28, .33–.34, .41–.57, and .64–.76 of AU section 508, <i>Reports on Audited Financial Statements</i> |
| AU section 534, <i>Reporting on Financial Statements Prepared for Use in Other Countries</i> |
| Paragraphs .14 and .16 of AU section 543, <i>Part of Audit Performed by Other Independent Auditors</i> |
| AU section 544, <i>Lack of Conformity With Generally Accepted Accounting Principles</i> |
| AU section 550, <i>Other Information in Documents Containing Audited Financial Statements</i> |
| AU section 551, <i>Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents</i> |
| AU section 552, <i>Reporting on Condensed Financial Statements and Selected Financial Data</i> |
| AU section 558, <i>Required Supplementary Information</i> |
| AU section 560, <i>Subsequent Events</i> |
| AU section 623, <i>Special Reports</i> |
| AU section 625, <i>Reports on the Application of Accounting Principles</i> |
| AU section 634, <i>Letters for Underwriters and Certain Other Requesting Parties</i> |
| AU section 711, <i>Filings Under Federal Securities Statutes</i> |
| AU section 722, <i>Interim Financial Information</i> |
| AU section 901, <i>Public Warehouses—Controls and Auditing Procedures for Goods Held</i> |