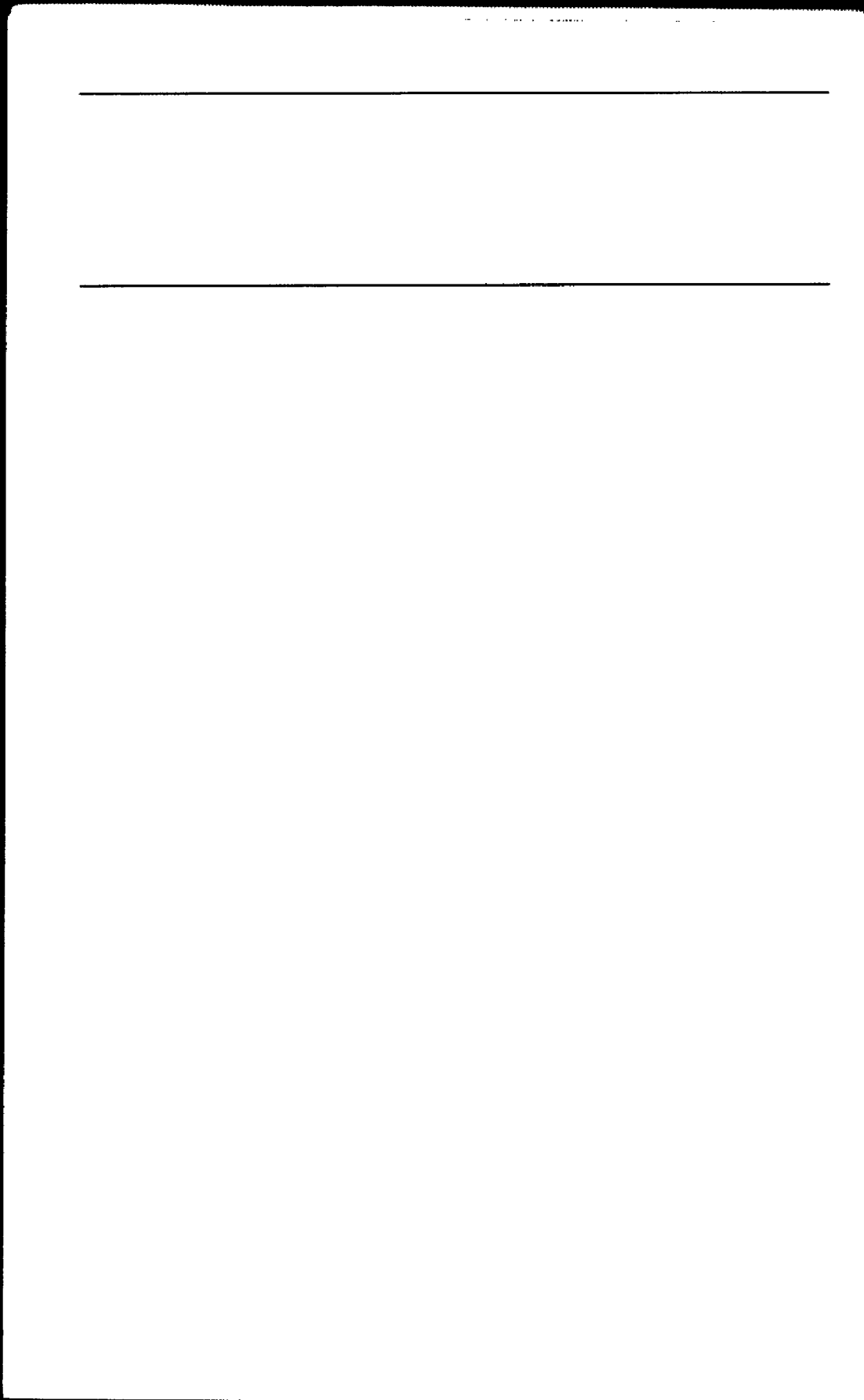


December 1989

**Assessing  
Compliance With  
Applicable Laws and  
Regulations**



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# Preface

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There is much concern about illegal acts and abuse occurring in the public and private sectors. The media frequently report instances of illegal acts and circumstances in which those in positions of authority and trust have failed to effectively fulfill their responsibilities.

There is also an increasing expectation that the audit/evaluation community must strengthen its efforts to evaluate compliance with laws and regulations and detect and report significant illegal acts and abuses. In 1988, the American Institute of Certified Public Accountants strengthened its requirements to test for errors, irregularities, and illegal acts. Also, GAO's Government Auditing Standards were revised in 1988 to strengthen requirements for testing compliance with laws and regulations.

The key compliance steps are to

- clearly define the assignment's objective(s),
- identify laws and regulations relevant to these objective(s),
- assess the inherent risk of noncompliance,
- assess internal control effectiveness,
- design audit steps directed toward areas of vulnerability, and
- report instances of noncompliance.

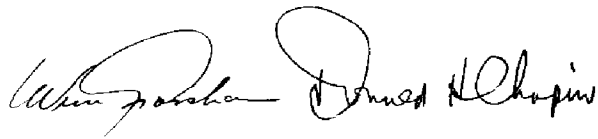
The purpose of this guide is to help GAO staff implement the strengthened requirement for detecting noncompliance. Chapter 1 provides a general overview of compliance testing. Chapter 2 discusses how assignment objectives influence compliance testing and how to identify applicable laws and regulations. Chapter 3 explains how to perform a vulnerability assessment to determine the extent of compliance testing. Chapter 4 discusses compliance testing and reporting requirements for performance audits. Chapter 5 addresses the requirements for financial audits.

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Preface

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# Contents

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Preface		1
Chapter 1		6
Introduction	Government Auditing Standards	6
	Purpose of Guide	7
	General Requirements	8
	Terms Defined	9
	What the Yellow Books Says	10
	Materiality/Significance and Sensitivity	11
	Coordination With OGC	12
	Due Care Concerning Illegal Acts and Abuses	13
Chapter 2		15
Identifying Applicable Laws and Regulations	Importance of Assignment Objectives	15
	Identifying Laws and Regulations	18
Chapter 3		23
Determining the Extent of Compliance Testing	Vulnerability Assessment	23
Chapter 4		32
Performance Audits: Audit Steps and Reporting Requirements	Case Example	32
	Reporting Requirements	40

---

Chapter 5		42
Financial Audits:	Case Example	42
Audit Steps and	Reporting Requirements	45
Reporting	Sample Compliance Report	46
Requirements	Sample Compliance Report	48

---

Table	Table 3.1: Relationships Between Inherent Risk, Internal Controls, Vulnerability, and Testing Extent	23
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**Abbreviations**

AICPA	American Institute of Certified Public Accountants
FIA	Federal Managers' Financial Integrity Act of 1982
GAO	General Accounting Office
GPM	General Policy Manual
IG	Inspector General
OGC	Office of the General Counsel
OSM	objectives, scope, and methodology
PM	Project Manual
SAS	Statements on Auditing Standards
S&Ls	savings and loan institutions

# Introduction

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This chapter discusses

- the government auditing standards contained in GAO's "Yellow Book,"
- the purpose of this guide,
- the general requirements and expectations for GAO staff to use professional judgment in designing and performing compliance tests,
- what the "Yellow Book" says,
- how materiality/significance and sensitivity influence testing,
- the need for coordination between auditors/evaluators and the Office of the General Counsel (OGC), and
- due care and precautions concerning illegal acts and abuses.

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## Government Auditing Standards

GAO's Government Auditing Standards (commonly referred to as the "Yellow Book") and chapters 4 ("Standards") of the General Policy Manual and the Project Manual (PM) require that all audits/evaluations include an assessment of compliance with relevant laws and regulations that are material to the assignment objectives.

For performance audits, the standard provides the following:

- **An assessment is to be made of compliance with applicable requirements of laws and regulations when necessary to satisfy the audit objectives.**
- **Where a compliance assessment is required, auditors should design the audit to provide reasonable assurance of detecting abuse or illegal acts that could significantly affect the audit objectives.**
- **Auditors should be alert to situations or transactions that could be indicative of abuse or illegal acts.**

For financial audits, the standard provides the following:



- **A test should be made of compliance with applicable laws and regulations.**
- **The auditor should design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts that could have a direct and material effect on the financial statement amounts or the results of financial-related audits.**
- **The auditor should also be aware of the possibility of illegal acts that could have an indirect and material effect on the financial statements or results of financial-related audits.**

Government organizations and programs are created and governed by laws and regulations whose purpose is to ensure that government activities achieve their objectives effectively.

Often these laws and regulations affect private organizations and individuals as well. For example, the federal government insures deposits in savings and loan associations (S&Ls) and regulates S&Ls to ensure that they are operated in a safe and sound manner and comply with laws and regulations.

Violation of laws and regulations can result in civil and criminal penalties and can have dramatic and profound adverse long-term implications for the government and the nation. For example, on June 16, 1989, GAO reported that the cost of rescuing failed S&Ls will exceed \$100 billion. (See report entitled Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices, GAO/AFMD-89-62.) According to GAO's report, there were numerous and sometimes blatant violations of laws and regulations and indications of fraud or insider abuse at all S&Ls reviewed.

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## Purpose of Guide

The purpose of this guide is to assist GAO staff in determining

- when testing for compliance with laws and regulations should be performed,
- how to identify the relevant laws and regulations,
- how to evaluate the likelihood that noncompliance could occur and not be detected or prevented by internal controls,
- to what extent testing is to be done, and
- how to deal with and report suspected or actual instances of noncompliance.

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**General  
Requirements**

GAO expects all audits/evaluations to be properly planned and to include steps to provide reasonable assurance—not absolute or complete—that material instances of noncompliance that directly relate to the assignment’s objective(s) are detected and reported. This guide provides principles and concepts to use in determining if assessment of compliance with laws and regulations is required and the tests to be done. The effectiveness of the steps depends on staff perception, judgment, and resourcefulness. Auditors/evaluators should not presume that agencies are in compliance but should do sufficient testing to provide reasonable assurance that noncompliance, which is individually or in the aggregate material, would have been identified.

Auditors/evaluators must perform sufficient steps to detect major noncompliance without spending an unreasonable amount of resources on those steps. Erring in either direction has undesirable consequences—too much audit effort would waste valuable resources needed elsewhere, while not enough work risks instances of material noncompliance going undetected.

This guide provides assistance for determining the audit/evaluation steps and procedures to be used to evaluate compliance with laws and regulations and to detect major noncompliance (errors, fraud, illegal acts, or irregularities) and abuse.

The standard does not expect auditors/evaluators to uncover every impropriety; instead, it requires reasonable tests to assure detection of major improprieties.

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## Terms Defined

Noncompliance with laws and regulations as used in this guide includes both intentional and unintentional acts as well as a variety of other terms, such as "fraud," "abuse," "errors," and "irregularities," and these and other terms are defined as follows:

Errors - Unintentional noncompliance with applicable laws and regulations and/or misstatements or omissions of amounts or disclosures in financial statements.

Fraud - Action that violates a fraud-related statute of the United States Code or a state statute.

Illegal acts - Failure to follow requirements of laws or implementing regulations, including intentional and unintentional noncompliance and criminal acts.

Criminal acts - An illegal act for which incarceration, as well as other penalties, is available if the government obtains a guilty verdict.

Civil acts - An illegal act for which penalties that do not include incarceration are available for a statutory violation. Penalties may include monetary payments and corrective actions.

Irregularities - Intentional noncompliance with applicable laws and regulations and/or misstatements or omissions of amounts or disclosures in financial statements.

Abuse is distinguished from noncompliance in that abusive conditions may not directly violate laws or regulations. Abusive activities may be within the letter of the laws and regulations but violate either

their spirit or the more general standards of impartial and ethical behavior. This guide does not provide an all-inclusive treatment of the subject of abuse, but see page 19 for additional guidance.

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**What the Yellow  
Book Says**

On performance and financial audits/evaluations, the Yellow Book requires auditors/evaluators to

- determine if assignment objectives require that tests of compliance with laws and regulations be performed;
- identify laws and regulations that apply to the entity to be audited/evaluated and that are relevant to assignment objectives;
- assess the risk that noncompliance with these laws and regulations could significantly affect the program operations or financial statements being audited/evaluated;
- consider whether internal controls deter or help detect noncompliance;
- design work steps to reasonably assure the (1) entity's compliance with relevant laws and regulations and (2) detection of errors, irregularities, abuse, or illegal acts that could significantly affect the assignment objectives;
- exercise appropriate caution in investigating illegal acts so as not to interfere with potential future investigations and/or legal proceedings;
- promptly prepare an audit/evaluation report that includes all significant or material instances of non-compliance; and
- promptly report all illegal acts that could result in criminal prosecution.

The Yellow Book also requires that financial audits be performed in accordance with the fieldwork and reporting standards prescribed by the American Institute of Certified Public Accountants (AICPA). AICPA has issued a series of Statements on Auditing Standards (SAS), and the following standards

are particularly applicable to detecting and reporting noncompliance with laws and regulations on financial audits:

- Compliance Auditing Applicable to Government Entities and Other Recipients of Governmental Financial Assistance (SAS 63),
- Consideration of the Internal Control Structure in a Financial Statement Audit (SAS 55),
- Illegal Acts by Clients (SAS 54), and
- The Auditor's Responsibilities to Detect and Report Errors and Irregularities (SAS 53).

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## Materiality/ Significance and Sensitivity

When performing an audit/evaluation and reporting results, GAO staff need to consider materiality/significance and sensitivity.

Materiality concerns the magnitude of omissions or misstatements of accounting information that, in the light of circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by omissions or misstatements. Materiality judgments involve both quantitative and qualitative considerations.

Significance concerns the importance, in relation to the audit objectives, of items, events, information, matters, or problems the auditor identifies.

Sensitivity involves how given matters will be perceived by others. It is possible for matters to be both material/significant and sensitive. For example, a former high-level official used influence to convince an agency to fund construction of certain projects and, for minimal effort, the former official was paid a large fee by the project developers. As reported, these situations of imprudent use of public funds could amount to hundreds of millions of dollars. Disclosures of these circumstances received a lot of publicity.

Generally, the greater the materiality/significance and sensitivity, the greater the degree of required compliance testing.

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## **Coordination With OGC**

Many of the matters discussed in this guide involve decisions that are essentially legal or have legal implications. Auditors/evaluators must consult with OGC in making decisions that are essentially legal. Examples include determining if (1) certain actions by an agency or others violate laws and regulations and (2) cases should be referred to law enforcement agencies for possible prosecution.

OGC may also be helpful to the audit team by providing advice in

- identifying laws and regulations relevant to assignment objectives,
- helping to determine whether assignment objectives require compliance testing,
- assessing susceptibility to noncompliance,
- developing tests for inclusion in assignment plans testing for compliance,
- reviewing entity actions to determine if laws and/or regulations have been violated, and
- determining whether noncompliance is material or significant.

Auditors/evaluators should exercise good judgment in deciding when coordination with OGC is appropriate. For example, if an audit/evaluation is started in a subject area that has not been reviewed by GAO for several years, consultation with OGC would be appropriate to ensure that all applicable laws and regulations are identified.

Conversely, if an assignment is started in a subject area in which there has been intense GAO audit/evaluation activity in recent years, the permanent GAO staff assigned to the agency audit site is likely to already be knowledgeable of applicable laws and

regulations and there may not be as compelling a need for direct OGC involvement.

Whenever there is reasonable cause to believe that coordination is necessary or desirable, auditors/evaluators should initiate contacts with OGC and, after discussion, decide whether direct OGC participation is appropriate.

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**Due Care  
Concerning Illegal  
Acts and Abuses**

Auditors/evaluators should exercise caution when dealing with suspected illegal acts and abuse.

During the initial stages of an assignment, they should ascertain whether other audit, evaluation, or investigative groups have initiated investigations into alleged illegal acts or abuses that might affect the assignment. (See PM, ch. 6.1.)

If, as the assignment proceeds, possible illegal acts or abuses are identified, auditors/evaluators should promptly consult with OGC for advice and assistance on how to proceed. Early consultation is particularly important in cases involving fraud and illegal acts carrying civil or criminal penalties. GAO Order 1130.1 contains instructions on how to handle these cases and how to refer them to federal law enforcement agencies.

The programming division should, in coordination with OGC, determine whether the audit/evaluation should continue, be modified to defer work relating to the violations, or be suspended.

If the assignment is a congressional request, GAO staff should discuss with the requester the need to defer or modify the scope of work until the investigation is completed and GAO evaluates the results. If the requester does not consent to changes that GAO believes necessary, the division directorate and the Office of Congressional Relations should be consulted before proceeding and the product should

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**Chapter 1**  
**Introduction**

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clearly disclose the requirements and constraints imposed on GAO's work.



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# Identifying Applicable Laws and Regulations

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This chapter discusses how assignment objectives influence the scope of compliance testing to be performed and how to identify applicable laws and regulations for compliance testing.

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## Importance of Assignment Objectives

Clearly defining the assignment objective(s) is a must for each audit, since it guides the development of the audit plan, as well as the determination of scope and methodology. Compliance testing for broadly stated assignment objectives is generally more difficult since many laws could be applicable and testing would normally be more extensive than a narrower-scoped assignment. Therefore, to the extent possible, the assignment objectives should be defined as precisely as possible to preclude unnecessary work, while meeting the purpose of the audit.

Because assignment objectives are so significant in determining the extent of compliance testing (as well as the extent of other audit/evaluation work), it is important that the objectives be fully understood and clearly stated. If the assignment is a congressional request, GAO should ensure that there is "a meeting of the minds" as to assignment objectives. If assignment objectives are not fully understood and clearly stated, work done may be more or less than is necessary. The Project Manual contains a more detailed discussion on establishing assignment objectives (ch. 6.1) and working with the Congress (ch. 3.1).

The probability or risk that noncompliance may occur and be material is the key factor in deciding how much compliance testing is required. A vulnerability assessment is the preferred technique of assessing the probability that applicable laws and regulations may not have been followed, and the internal controls assessment shows the likelihood of such noncompliance being detected or prevented. Performing a vulnerability assessment is discussed in chapter 3 of this guide.

The following four cases illustrate the relationship between the assignment objective(s) and the determination of whether compliance testing is necessary and the extent of testing.

Case 1. If GAO is asked to determine how much grant money is awarded to the states without determining the appropriateness of that award, the assignment would be designed to compile information to respond to the question and would not normally include steps to test for noncompliance. The objectives, scope, and methodology (OSM) section of the product should state clearly the limited nature of the information provided. A statement of non-conformity with generally accepted government auditing standards would not be required because tests for noncompliance would not reasonably be expected given the limited nature of the assignment objective. Depending on the circumstances, such an effort might be categorized as an "other assignment" rather than an audit/evaluation. (See General Policy Manual, p. 4.0-2.)

Case 2. If the assignment objective is to determine if a certain grant award was proper, the applicable laws and regulations should be identified and then the grant award should be examined to see if these laws and regulations were complied with. Auditors/evaluators should also assess the inherent risk of noncompliance and obtain an understanding of internal controls applicable to grant awards. If non-compliance is detected, the internal controls that were supposed to prevent or detect the noncompliance should be identified as a basis for establishing its cause. If internal controls are weak or non-existent, widespread noncompliance may have occurred and GAO staff should consider whether the assignment scope should be expanded, a follow-up assignment should be performed, and/or the matter should be reported to the responsible agency. The assignment product should disclose weaknesses identified.

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**Chapter 2**  
**Identifying Applicable Laws**  
**and Regulations**

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Case 3. If the assignment objective is to make an overall assessment of whether an agency awards grants in accordance with applicable laws, the steps called for in case 2 would be expanded to (1) test internal controls and assess the risk that the internal controls will not prevent/detect noncompliance and (2) examine a sample of actual grant awards to ascertain if the agency followed the applicable laws when awarding grant funds. However, specific steps would not be required at the user level to test for possible recipient misuse of the funds since the assignment objectives do not concern recipients' use of funds.

In cases 1, 2, or 3, if credible indications of illegal or inappropriate use of funds by grant recipients are detected (even though audit/evaluation steps were not intended to identify such indications), arrangements should be made to (1) expand the scope of the assignments, (2) schedule follow-up assignments, or (3) refer the matters to the agency's Inspector General (IG) or GAO's Office of Special Investigations for further review. If suspected illegal acts are not pursued and resolved by expanding the current assignments, the OSM sections should describe what further action is being taken to resolve the matters.

Case 4. If the assignment objective is to test proper use of grant funds, then testing of recipient's eligibility and use of the funds becomes a paramount point of the audit/evaluation and extensive testing would be required to determine compliance with laws and regulations directly relating to recipients' use of grant funds. Extensive testing would be required because multiple levels (federal, state, and local) and organizations would be involved. Each organization has different rules, risks, and internal control structures.

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## Identifying Laws and Regulations

During the early phase of an assignment where compliance assessment is called for by the assignment objectives, auditors/evaluators should identify the laws and regulations that apply to the assignment subject area and might significantly affect assignment objectives.

The first step in this process is to identify general laws and regulations applicable to the subject of the assignment. For example, on an assignment involving procurement, the Federal Acquisition Regulation and the Competition-in-Contracting Act might apply.

The second step is to identify more specific laws and regulations applicable to the agency or activity. For example, the agency may have its own procurement regulations or procedures.

As the GAO staff gain a greater familiarity with the activities being examined, the third step is to identify those provisions of laws and regulations relating directly to assignment objectives. For example, if an assignment objective is directed toward assessing government contractors' employment and personnel practices, the applicable laws and regulations would be those related to that subject and other laws and regulations (e.g., those relating to contract pricing or timely delivery of products) would not be of paramount importance.

In consultation with the Office of the General Counsel, the sources of information that the GAO staff can use to identify applicable laws and regulations include

- the United States Code,
- the Code of Federal Regulations,
- the Federal Acquisition Regulations,
- Office of Management and Budget publications,
- prior GAO products,
- permanent files kept by GAO audit sites,
- the agency's OGC,

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**Chapter 2  
Identifying Applicable Laws  
and Regulations**

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- the agency IG or the equivalent, and
  - agency program representatives.
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**Performance  
Audits/Evaluations**

On performance audits/evaluations, the assignment plan should identify the steps to be performed to provide reasonable assurance of detecting noncompliance with laws and regulations that could significantly affect the assignment objectives. Usually, such laws and regulations are those directly relating to the particular programs or activity, such as agricultural price support, defense weapons systems, veterans benefits, or student loans. However, the assignment plan should also identify steps to test for compliance with indirect laws and regulations which, if violated, could have a material impact on the objective. Such indirect laws and regulations include those relating to

- contract and procurement improprieties;
- conflict-of-interest and ethics violations;
- fraud, waste, and abuse in government programs, activities, and functions;
- environmental issues; and
- violations of equal employment opportunity requirements.

At times, these indirect laws may have a more profound impact on the audit objective than the direct laws. Therefore, staff must be especially alert to these potential impacts and, as warranted by the vulnerability assessment, design the necessary steps to reasonably detect major noncompliance impacts.

Government auditing standards also require that performance audits be designed to provide reasonable assurance of detecting abuse (as well as illegal acts) that could significantly affect the assignment objective. The elements of significance and relationship to assignment objectives are important. Auditors/evaluators are not expected to detect all

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**Chapter 2  
Identifying Applicable Laws  
and Regulations**

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safety and health, environmental protection, equal employment, and theft.

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**Chapter 2**  
**Identifying Applicable Laws**  
**and Regulations**

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- imprudently using funds to purchase unneeded items at year-end,
- being unreasonably and unjustifiably lenient in reducing fines or penalties, and
- the recovering of overpayments by states or other intermediaries under programs financed by the federal government without returning the federal government's share of recoveries.

In addition to performing the steps and procedures specifically intended to detect noncompliance and abuse, GAO staff should continually be alert for "red flags," or indicators of noncompliance with laws, regulations, and abuse as audit/evaluation work is performed. (See p. 26.) If such indicators are noted and if the potential noncompliance is significant and related to the assignment objectives, the assignment plan should be modified to determine if the potential noncompliance actually occurred, how it affected assignment objectives, and how it should be reported. (For further guidance on how to proceed when actual or suspected illegal acts and abuses are detected, see p. 13.)

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**Financial Audits**

On financial statement and financial-related audits, steps should be performed to provide reasonable assurance of detecting violations of laws and regulations that could have a material effect on financial statement amounts or the results of a financial-related audit. Laws and regulations against which compliance should be assessed include specific laws and regulations applicable to the entity being audited and laws and regulations generally applicable to all federal agencies. Examples of specific laws and regulations include legislation that created and funds the agency and its programs. Examples of laws and regulations that are generally applicable to all agencies include the Prompt Payment Act; the Anti-Deficiency Act; the Federal Managers' Financial Integrity Act of 1982 (FIA); and laws and regulations concerning the proper obligation and recording of appropriated funds, occupational

possible abuse; instead, they are required to undertake steps that are appropriate in the circumstances to identify abuse that could have a major impact on the results of the audit/evaluation.

Determining whether abuse has occurred is usually more difficult than determining noncompliance with laws and regulations since there generally is no clear criterion for making these judgments. Tests of compliance with laws and regulations to discover illegal acts will normally serve to help identify abusive situations that violate the spirit but not the letter of the laws and regulations. To identify these situations, the auditor/evaluator in conducting tests of compliance must have an overall comprehension of the purpose of the law and be sensitive to that purpose in making tests.

Another kind of abuse may violate general standards of impartial and ethical behavior. The auditor/evaluator in pursuing work, especially evaluation of the internal control environment, must be sensitive to the possibilities of abuse and pursue significant matters that come to his/her attention that may violate general standards of impartial and ethical behavior.

Presentations regarding abuse must be fair and objective and should convince the reader that the situation is improper and needs to be corrected.

Examples of abuse include

- allowing former high-level officials access to current officials and giving them the opportunity to influence decisionmaking through preferential treatment on grants or contracts or in dispensing favors,
- subordinates' performing tasks of a personal nature for supervisors,
- making unnecessary trips at government expense,
- assigning government inspectors an unrealistic "quota" of violations to detect or fines to assess,



# Determining the Extent of Compliance Testing

## Vulnerability Assessment

A vulnerability assessment should be made to determine the extent of compliance testing to be performed.

**A vulnerability assessment determines the probability that noncompliance and abuse, which is individually or in the aggregate material, could occur and not be prevented or detected in a timely manner by internal controls.**

The assessment evaluates (1) the inherent risk of a law or regulation to noncompliance and abuse before considering internal controls and (2) whether internal controls will prevent or detect noncompliance and abuse. (See table 3.1.)

**Table 3.1: Relationships Between Inherent Risk, Internal Controls, Vulnerability, and Testing Extent**

Inherent risk	x	Internal controls	=	Vulnerability/testing extent
High		Weak Adequate Strong		High Moderate to high Low to moderate
Moderate		Weak Adequate Strong		Moderate to high Moderate Low
Low		Weak Adequate Strong		Low to moderate Low Very low

The extent of compliance testing is directly related to an activity's degree of vulnerability. The higher the vulnerability, the more extensive the compliance testing needs to be and vice versa. Thus, even

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**Chapter 3  
Determining the Extent of  
Compliance Testing**

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though an activity may be inherently risky to non-compliance and abuse, strong internal controls can reduce vulnerability to a relatively low level, thereby reducing necessary compliance testing to a relatively low level.

The rationale for performing a vulnerability assessment is that auditors/evaluators can limit testing and focus on those areas most vulnerable to non-compliance and abuse if internal controls are found to be reliable. This produces a more-cost-effective and timely audit/evaluation.

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**Inherent Risk**

**Inherent risk is the probability that a law/regulation related to assignment objectives will not be complied with or that the area being reviewed is highly susceptible to noncompliance (e.g., pilferage of cash).**

Inherent risk is assessed before considering whether the internal controls would prevent or detect such noncompliance or abuse. Assessing inherent risk involves

- considering the requirements of applicable laws and regulations,
- establishing susceptibility to noncompliance,
- assessing management's commitment to reduce and control noncompliance,
- determining whether previously identified noncompliance problems have been corrected, and
- testing transactions.

**Considering Requirements of Laws and Regulations**

Chapter 2 of this guide discusses how to identify the laws and regulations applicable to an assignment. Some questions to consider are as follows:

- Are the laws and regulations readily identifiable, vague, complex, or contradictory?

Laws and regulations that are clear, understandable, and consistent with other laws and regulations are easier to adhere to and to check for compliance than laws and regulations lacking these characteristics.

- Do the laws and regulations relate to a new program, or have they undergone recent or frequent major changes?

Laws and regulations that have recently been implemented or changed may be more likely to be violated because people are less familiar with them.

Susceptibility to  
Noncompliance

GAO staff should also identify the characteristics that increase the susceptibility to noncompliance. Some questions to consider are as follows:

- Do incentives of noncompliance outweigh the potential penalties?

If the law or regulation provides a benefit based on need, individuals will have an incentive to overstate their need in order to qualify or to get a larger benefit.

- Is it practicable or reasonable to expect compliance, or are the laws and regulations so burdensome or onerous that noncompliance could reasonably be expected?
- Does the activity have numerous transactions?

The more transactions there are, the greater the chances that noncompliance could occur due to errors, irregularities, and abuse. Also, a large number of transactions increases the difficulty of detecting noncompliance.

- Have important government activities/programs been contracted out or delegated to those outside the government without ensuring that adequate

internal control systems and active monitoring/oversight are in place?

- Does the activity have a significant amount of assets that are readily marketable (i.e., cash, securities, or drugs) or could be used for personal purposes (i.e., tools, cars, auto repair parts, or computers)?

Such assets are very susceptible to improper use or theft.

- Are significant benefits of government programs extended to individuals or corporations by government officials whose actions are generally not subject to public examinations and evaluations?

Auditors/evaluators should be alert for and consider any “red flags,” or indicators of susceptibility to noncompliance. Any such indicators would vary on the basis of the subject and the objective of the audit. The following are examples of susceptibility indicators that might be identified:

- a pattern of certain contractors' bidding against each other or, conversely, certain contractors' not bidding against each other;
- use of materials on commercial contracts that were intended for use on government contracts;
- a high default rate on government-backed loans;
- complex transactions;
- poor records/documentation;
- activities that are dominated and controlled by a single person or small group;
- unreasonable explanations to inquiries by auditors/evaluators;
- auditee annoyance at reasonable questions by auditors/evaluators;
- employees' refusal to give others custody of records;
- employees' refusal to take vacations and/or accept promotions; and

- extravagant lifestyle of employees.

Management Commitment    GAO staff should consider management's commitment to reduce and control noncompliance. A strong commitment by management to comply is a positive factor in reducing the risk of noncompliance. Some questions to consider are as follows:

- Have problems been repeatedly disclosed in prior audits/evaluations by GAO, the Inspector General, or others?
- Does management promptly respond when problems are first identified?
- Are recurring complaints received through "hot line" allegations?
- Is management willing to discuss its approach toward compliance?
- Is management knowledgeable of the subject area and potential problems?
- Does management have a constructive attitude, including a willingness to consider innovative approaches?
- Is there a stable management team with continuity and a good reputation, or is there high turnover and/or poor management reputation?

Testing Transactions    The final step of assessing inherent risk involves testing a limited number of transactions. This testing usually occurs during the survey stage of an assignment and is not intended to be a representative sample of transactions. Rather, GAO staff should perform limited work to gain a better understanding of the processes followed by the agency and to confirm other observations made about inherent risk of noncompliance.

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Internal Controls    **Internal controls consist of policies and procedures used to provide reasonable assurance that goals and objectives are met; resources are adequately safeguarded, efficiently utilized, and**

**reliably accounted for; and laws and regulations are complied with.**

Evaluating internal controls involves

- identifying internal control objectives (policies) that management has designed to ensure that laws and regulations are complied with and the control environment,
- identifying key internal control techniques (procedures) that management has established to achieve objectives,
- testing control procedures, and
- identifying needed follow-on actions.

In some instances, GAO staff may be able to make this evaluation on the basis of recently completed audits/evaluations.

**Identifying Objectives**

The control objective is a positive thing that management tries to attain or an adverse condition/negative effect that management is seeking to avoid. For example, the Department of Education has a control objective of not paying interest and special allowances under the Stafford Student Loan Program for ineligible students. (See case example on p. 32.) Auditors/evaluators should determine what control objectives related to assignment objectives management has established.

The control environment reflects the overall attitude toward and awareness of management regarding the importance of internal controls. A good control environment is a positive factor in establishing and enhancing the effectiveness of specific policies and procedures, while a poor control environment has the opposite effect. Factors affecting the control environment include

- management's philosophy and operating style (tone at the top);
- the entity's organizational structure;

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**Chapter 3**  
**Determining the Extent of**  
**Compliance Testing**

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- methods of delegating authority and responsibility;
- management's methods for monitoring and following up on performance, including internal auditing and corrective action taken on recommendations; and
- personnel policies and practices.

Identifying Procedures

Control objectives and environment represent those goals and actions management wishes to achieve, while control procedures are the specific steps designed and prescribed by management to provide reasonable assurance that its control objectives will be achieved. For example, to limit spending to the amounts appropriated, government organizations have implemented detailed procedures for controlling expenditures. The control objective is to limit spending to the amount appropriated, and the control procedures are those steps that must be performed before funds can be obligated and/or spent. These steps may include such actions as requiring certification by the accounting department that sufficient funds are available before obligating or expending funds.

The auditor/evaluator can obtain information on the control environment, objectives, and procedures by reading agency manuals, reviewing past audit/evaluation reports, interviewing management and employees, and making observations.

Because of inherent limitations in the design and the operation of any internal control system, auditors/evaluators should not expect internal controls to prevent or detect all instances of noncompliance or abuse. The most pervasive limitation is that the cost of internal controls should not exceed their benefits. In deciding how extensive the system of internal controls should be, management compares the costs of more controls with the benefits to be gained.

Other limitations include the possibility that management may override the internal control system; employees may secretly be working together (collusion) to avoid or circumvent the controls; and employees may not be correctly applying the control technique due to fatigue, boredom, inattention, lack of knowledge, or misunderstanding. As a result, auditors/evaluators should always test actual transactions to have a reasonable basis for evaluating internal controls.

The auditors'/evaluators' understanding of the internal control system should be documented in the workpapers. This can be done through flowcharts; narratives; questionnaire responses; records of interviews; and copies of policies and procedures, documents, and records.

Testing Control  
Procedures

For internal control procedures to be effective, they must be designed to achieve the intended objective(s) and must be correctly and consistently applied by the authorized employee(s). The best-designed internal controls are of little value if the procedures are not correctly followed. For example, if the entity has a procedure requiring the manager's approval for all purchases over \$25,000 but the manager does not review the purchase orders, this procedure will not be very effective in preventing or detecting unnecessary purchases.

Testing internal controls consists of the following steps:

- defining what constitutes effective internal controls;
- selecting a small sample of transactions, either randomly or nonrandomly;
- evaluating whether the sample transactions were executed in accordance with the laws and regulations and internal controls;
- documenting the evaluation results; and



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**Chapter 3**  
**Determining the Extent of**  
**Compliance Testing**

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- determining the probability that noncompliance will not be detected or prevented by the internal controls.

Auditors/evaluators can use the results of the transaction tests to assess the probability that internal controls will not prevent or detect noncompliance.

Needed Corrective Actions    If testing reveals material noncompliance or abuse, the auditor/evaluator should determine what internal controls were intended to prevent or detect the noncompliance or abuse and ascertain the reasons they did not. If internal controls are weak or nonexistent, many more transactions may be in noncompliance. Auditors/evaluators should consider (1) expanding tests to determine the impact of weaknesses on assignment objectives and of doing follow-on work later or (2) referring the matter to a third party, such as the agency's IG.

\* \* \* \* \*

A detailed discussion of internal controls is contained in GAO's Guide for Incorporating Internal Control Evaluations Into GAO Work.

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# Performance Audits: Audit Steps and Reporting Requirements

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This chapter discusses a case example of how to make a vulnerability assessment and determine the extent of compliance testing, expected under conditions of high and moderate vulnerability. It also discusses how to report noncompliance.

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## Case Example

The following case illustrates how to apply the requirements, the concepts, and the principles discussed in this guide to an assignment. The circumstances of this case are hypothetical and are intended to illustrate the factors affecting the extent of compliance testing.

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## Assignment Objectives

Assume that GAO has been requested to determine if the Department of Education is paying the correct amount of interest and special allowance (interest subsidy) to lenders for eligible students under the Stafford Student Loan Program.

## Background

Under the program, private lenders make loans at low interest rates to qualified students attending approved educational institutions. Education pays the interest while the loan recipient attends school and for a stipulated time thereafter (the grace period). Education also funds special allowance payments during the life of the loan to provide lenders the difference between the loan interest rate and the rate on 90-day Treasury bills, plus 3-1/4 percent. For fiscal year 1988, Education reported that it paid about \$2.4 billion in interest and special allowances.

## Assignment Approach

During the survey stage, auditors/evaluators should identify the laws and regulations directly applicable to Education's policies and procedures in making loans and determinations of the proper interest and special allowance payments. Subsequent steps should include

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**Chapter 4**  
**Performance Audits: Audit**  
**Steps and**  
**Reporting Requirements**

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- risk assessment—assessing the likelihood that such payments may be significantly incorrect,
- internal control assessment—assessing internal control effectiveness to prevent and/or detect incorrect payments, and
- compliance testing—determining the extent of compliance testing on the basis of the above steps.

These efforts focus on formulating audit/evaluation steps and procedures for inclusion in the assignment plan to provide reasonable assurance of detecting significant errors or noncompliance during implementation.

The primary laws and regulations identified as directly applicable to assignment objectives are

- the Higher Education Act of 1965, as amended;
- Education's program regulations;
- recent appropriation acts;
- regulations or guidelines issued by state agencies acting as intermediaries and performing some functions for Education; and
- the Financial Integrity Act.

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**Risk Assessment**

The first step of the vulnerability assessment involves assessing the inherent risk that Education's interest and special allowance payments may be incorrect, may be paid to the wrong lender, or may be paid on behalf of ineligible persons. After obtaining a good understanding of applicable laws and regulations, auditors/evaluators should formulate questions to be answered to discern the inherent risk, such as the following:

- Have past efforts by GAO and other audit/evaluation groups identified significant erroneous payments of interest and special allowances? If so, has Education been slow in implementing corrective action?
- Are Education's laws and regulations complex and sometimes difficult to understand?

- Have there been frequent changes in applicable laws and regulations?
- Do students have an incentive to withhold information and/or provide inaccurate information to lenders, educational institutions, intermediaries, and/or Education that would cause interest and special allowance overpayments?
- Do the lenders have a disincentive to get and use current information?
- Does the program involve numerous lenders and borrowers?
- Is program management highly decentralized? Are significant loan decisions made by many persons at widely scattered locations? (Too much decentralization without adequate monitoring and control may increase the risk of misstatements.)
- Are there numerous transactions?
- Are significant aspects of the program (e.g., approval of applicants for loans and determining loan amounts) administered by those not under Education's direct control (e.g., employees of lenders, educational institutions, and intermediaries)?
- Do lenders, educational institutions, and/or intermediaries have difficulty maintaining a staff with adequate technical knowledge to ensure accurate and consistent program administration?
- Is there a lack of incentives for lenders, educational institutions, and intermediaries to carefully fulfill their program responsibilities? Are the penalties for doing a poor job insignificant or nonexistent?

"Yes" answers to the above questions generally indicate high risk, whereas "no" answers indicate low risk.

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**Internal Control**  
**Assessment**

The second step of the vulnerability assessment involves assessing internal control effectiveness. To make this assessment, auditors/evaluators should formulate questions focusing on understanding the internal control structure, determining if internal controls have been placed in operation, and testing

their effectiveness. In this case, the following questions might be addressed:

- Has Education declared its internal control objectives for interest and special allowance payments? Are they compatible with applicable laws and regulations?
- Have internal control procedures been prescribed? Do they present a logical sequence of steps which, if followed, will limit payments to those made on behalf of eligible students for appropriate periods?
- Does Education assess lenders' internal controls before allowing them to participate in the program? Has Education specified minimum systems and internal controls as a requirement before approval?
- What is the attitude of Education top management toward monitoring the program and taking actions, when needed, to correct any problems in program administration? Do the same problems recur without management attempts to correct them? Are corrective actions promised in response to audit/evaluation recommendations actually implemented?
- What were the results of any Education internal studies or reviews (including Financial Integrity Act reviews) of the program? For example, has the Inspector General recently examined the program? What were the findings and conclusions and any actions taken?
- What reviews or monitoring activities does Education perform to determine if lenders (1) verify applicants' income and resources to determine eligibility and (2) fulfill other responsibilities?
- Does Education verify that lenders determine the date that students graduate or stop attending school? (This date determines when borrowers, rather than Education, should begin paying loan interest.)
- Has Education spelled out minimum follow-up times with schools to confirm student status?
- Does Education test-check lenders' quarterly billings?

- How does Education ensure that quarterly interest and special allowance billings cover only approved loans for students in an approved status?
- How does Education ensure that there are no duplicate billings and that the interest and special allowance costs attributable to each approved student are paid only once? (Lenders and secondary-market institutions frequently buy and sell insured student loans, and there is the possibility of overlapping or duplicate billings for a single student.)

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## Compliance Testing

Case 1: High Vulnerability      As a result of information developed during the vulnerability assessment, assume that auditors/evaluators conclude that inherent risk is high; internal controls are weak; and as a result, the assignment plan must provide for extensive testing to determine compliance with laws and regulations. Tests should be directed toward those areas deemed most vulnerable to noncompliance and abuse. For example, such tests might include the following:

- Select a sample of lenders' billings that will provide a reasonable basis for determining the reliability of the payment process.
- Verify that the students met financial and other eligibility requirements by examining documents such as loan applications, tuition and other relevant costs, copies of tax returns, etc.
- Verify that the loans were approved for insurance under the program.
- Verify that schools were on Education's approved list.
- Determine that the correct interest rate was used to compute interest.
- Determine whether borrowers were active students (or were in the grace period) to decide who was liable for the interest.

- Recompute loan balances to verify that the lenders correctly computed them.
- Verify that lenders had the loan in their portfolios for the billing periods in question. (Lenders often sell loans to other institutions in what is commonly referred to as the secondary market.)

For each of the above tests, auditors/evaluators should also devise detailed tasks necessary to perform the tests. For example, in determining whether borrowers were active students (or were in the grace period) (thus making Education liable for loan interest payments), specific tasks could include the following:

- Check individual loan files at lending institutions to determine if lenders inquired whether borrowers were active students at the school.
- If schools responded to lender inquiries, note dates of student attendance and credit hours taken.
- Compare dates of attendance with the periods covered by the lenders' interest billings paid by Education to see if they correspond.
- If lenders' files do not contain needed information, contact schools and request dates of student attendance.

The above tests and tasks illustrate the work steps that might be used in the example. In practice, the work to be done must be adapted to the needs of a particular assignment, including time and cost considerations.

Throughout the assignment, auditors/evaluators should remain alert for indications of violations of indirect laws and regulations that could significantly affect assignment objectives. If such indications are noted, compliance tests should be extended to determine the impact of any such violations. If such violations concern possible illegal acts and abuses, caution should be used to ensure that

GAO does not interfere with, jeopardize, or duplicate any ongoing or planned investigation and/or proceedings. (See p. 13.)

Case 2: Moderate  
Vulnerability

As an alternate scenario, assume that auditors/evaluator conclude that although inherent risk is high, internal controls are strong and, as a result, there is a moderate vulnerability to noncompliance and the assignment plan should provide a moderate degree of testing. As in the high vulnerability assessment, the tests should be designed to achieve the assignment objective and be directed toward those areas deemed most vulnerable to noncompliance and abuse.

Assume that one principal consideration influencing the assessment of strong internal controls was a recent audit by Education's Inspector General of interest and special allowances. Assume that GAO inquiries have determined that the IG audit

- was comprehensive in scope, examining interest and special allowance payments made to a representative sample of lenders over a wide geographical area;
- was carefully planned and supervised, was based on a logical methodology, and included an evaluation of internal control effectiveness; and
- identified significant overpayments and underpayments and made recommendations for improvement, which Education management agreed to implement.

However, assume that the IG audit did not verify that (1) the schools had been approved by Education for program participation and (2) lenders had the loans in their portfolios and the loans had not been sold to secondary-market institutions.

Under these circumstances, GAO's audit tests might include



- reviewing the workpapers to examine the adequacy and the thoroughness of IG work,
- making supplemental tests of a small judgmental sample of transactions examined by the IG or similar transactions,
- determining if the corrective actions promised by Education management have been implemented, and
- selecting a representative sample of lenders' billings and determining whether (1) the schools were on Education's approved list and (2) lenders had the loans in their portfolios.

Auditors/evaluators would be expected to design detailed tasks to perform the above tests. For example, to determine if lenders had the loans in their portfolios, the following tasks might be performed:

- Obtain a computer printout showing borrowers' identification numbers at lenders selected for examination.
- Select a representative sample from the computer printout and examine lender documentation to confirm that loans were in their portfolios and were not sold to secondary-market institutions.

**Case 3: Low Vulnerability**

This case does not lend itself to a low vulnerability assessment because of the inherent risk.

In situations of low vulnerability, the following minimum steps should be included in the assignment plan:

- Review Education's latest FIA and IG reports to determine whether issues were reported concerning payment of interest and special allowance.
- Discuss with the division's FIA team members whether they have any knowledge of internal control weaknesses not disclosed in Education's FIA report.
- Discuss with Education officials and obtain their comments and any available reports, management

studies, or other information relating to (1) whether interest and special allowance payments were evaluated under FIA and what the results were, (2) whether control objectives and procedures were established and tested to ensure they worked as intended, and (3) how adequate internal controls were to ensure proper interest and special allowance payments.

- Check for proper implementation of prior recommendations.
- Select a sample of lenders' billings and determine if Education records show that borrowers were eligible for loans.

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## **Reporting Requirements**

GAO's government auditing standards require the following:

**The report should include all significant instances of noncompliance and abuse and all indications or instances of illegal acts that could result in criminal prosecution that were found during or in connection with the audit.**

GAO products should contain sufficient information to place the noncompliance in proper perspective. For example, if GAO finds that a single contract was awarded contrary to laws or regulations, the product should disclose the total number and the dollar values of contracts examined, as well as the dollar value of the improperly awarded contract.

If inclusion in the overall product of instances involving possible criminal prosecution would delay or compromise investigative or legal proceedings or otherwise preclude the product from being released to the public, such instances should be covered in a separate report to officials of the audited agency, law enforcement agencies, or the requester, as appropriate. The Office of the General Counsel should be consulted in determining how possible criminal prosecution should be reported.

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**Chapter 4**  
**Performance Audits: Audit**  
**Steps and**  
**Reporting Requirements**

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Other instances of noncompliance not included in the overall product because of insignificance should be separately communicated to agency management, the IG, internal auditors, or the requester, as appropriate. The overall product should state that the noncompliance is being separately reported.

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# Financial Audits: Audit Steps and Reporting Requirements

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This chapter discusses a case example illustrating how to make a vulnerability assessment and determine the extent of expected compliance testing, assuming conditions of moderate vulnerability. It also discusses the requirement for preparing a compliance report on testing results.

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## Case Example

The following case illustrates how to apply the requirements, the concepts, and the principles discussed in this guide to a financial audit. The conditions described in this guide are hypothetical and are intended to illustrate the factors that affect the extent of compliance testing.

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## Assignment Objectives

Assume that GAO has been requested to determine if Education has fairly stated the interest and the special allowance paid for the Stafford Student Loan Program loans for the fiscal year ended September 30, 1988.

## Background and Assignment Approach

The background and the assignment approach would be substantially the same as those under the case discussed in chapter 4. In this chapter's example, the questions to be asked during the risk and internal control assessment and the resulting compliance tests would be tailored toward determining whether Education fairly stated the interest and special allowance payments. In the example in chapter 4, the thrust of the questions and tests is to assess whether Education had procedures in place to ensure that it paid the correct amount of interest and special allowances.

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## Risk Assessment

The first step of the vulnerability assessment involves assessing the inherent risk that Education's reported payment of interest and special allowances may be misstated. After obtaining a

good understanding of applicable laws and regulations, auditors/evaluators should formulate questions to ask to discern the inherent risk. Besides the questions identified in the prior case studies (see p. 33), examples of other questions to ask include the following:

- Because of budgetary constraints or other factors imposed on the program, are there incentives for Education to overstate or understate interest and special allowance payments?
- Are there any penalties for misreporting of interest and special allowance payments?
- Are interest and special allowance payments based on a relatively simple calculation, or is the determination a complex one using various interest rates?

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**Internal Control**  
**Assessment**

The second step of the vulnerability assessment involves determining internal control effectiveness. To do this, auditors/evaluators should formulate questions focusing on understanding the internal control structure, determining if internal controls are in operation, and testing their effectiveness. Besides the questions identified in the previous case study (see p. 35), some additional questions to consider are as follows:

- What accounting procedures have been implemented to maintain control over interest and special allowance payments? Do they provide a reasonable system for ensuring accuracy of recorded amounts?
- Has a financial audit been performed of Education's statement of interest and special allowances by the Inspector General or an independent auditor? If so, what were the results?
- Do independent accountants make financial audits of the lenders? If so, does Education consider these audit results in calculating outstanding loan balances and interest and special allowance payments?
- Does Education compare its records of interest and special allowance payments with lenders' records? If so, are any differences reconciled?

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**Compliance Testing**

As a result of information developed during the vulnerability assessment, assume that auditors/evaluators conclude that inherent risk is high but that internal controls are strong and, as a result, the assignment plan must provide for moderate testing to determine compliance with laws and regulations. For example, such tests might include the following:

- Examine Education's summary account for interest and special allowance payments. Select a sample and trace selected entries to supporting subsidiary accounts or other documentation. Fully resolve any discrepancies.
- Obtain from lenders a printout or data tape showing the individual loans for which they billed Education for interest and/or special allowance payments for the fiscal year ended September 30, 1988; the payment amounts; and the loan balances.
- Test the data for accuracy, unusual items, and completeness.
- Test the reasonableness of interest and special allowance payments by relating them to loan balances.
- Take a sample of payments and trace them to lenders' quarterly billings. Reconcile any discrepancies.
- Determine how lenders periodically notify borrowers of outstanding balances. For loans in the sample, examine loan notices sent to borrowers and compare them with Education's records. Reconcile any discrepancies between Education records and notices to borrowers.
- Examine lender records and files to determine if borrowers reported discrepancies between loan balances and balances reported by lenders.

As in the prior case examples, auditors/evaluators would be expected to devise detailed tasks to effectively perform the above tests.

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## Reporting Requirements

GAO's government auditing standards require the following:

**The auditors should prepare a written report on their tests of compliance with applicable laws and regulations. This report, which may be included in either the report on the financial audit or a separate report, should contain a statement of positive assurance on those items which were tested for compliance and negative assurance on those items not tested. It should include all material instances of noncompliance and all instances or indications of illegal acts which could result in criminal prosecution.**

If auditors/evaluators find no instances or indications of material noncompliance, the compliance report should include

- a statement of positive assurance that the tests results indicate that with respect to the items tested, the entity complied in all material respects with the laws and regulations referred to in the scope and
- a statement of negative assurance that with respect to items not tested, nothing came to the auditors'/ evaluators' attention that caused them to believe that the entity had not complied in all material respects with these laws and regulations.

If auditors/evaluators find instances of material noncompliance, they should state that they considered these instances in forming their opinion on the financial statements and whether these instances affected their opinion and how. The statement on assurance should be similar to the following:

"Except as described above, the results of our tests of compliance with laws and regulations indicate that with respect to the items tested, the Administration complied in all material respects with the provisions referred to above. With respect to items not tested, nothing came to our attention that caused us to believe that the Administration had not complied in all material respects with those same provisions."

Instances of noncompliance with laws and regulations that are nonmaterial from a quantitative and qualitative perspective should be reported to top management via a management letter. If applicable, the compliance report should state that the auditors/evaluators found instances of nonmaterial non-compliance with laws and regulations that are being separately reported to management.

Further information on compliance reports can be found in chapter 5 of the Yellow Book and Statement on Auditing Standards 63 issued by the American Institute of Certified Public Accountants: Compliance Auditing Applicable to Government Entities and Other Recipients of Governmental Financial Assistance.

Two sample compliance reports are presented below.

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## Sample Compliance Report

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No Material  
Noncompliance

To the Administrator  
Federal Administration Agency

We have audited the consolidated financial statements of the Federal Administration Agency (Administration) for the fiscal year ended September 30, 19xx, and have issued our opinion thereon dated [date of opinion]. As part of our audit, we tested the Administration's compliance with certain laws and regulations that, if not followed, could have a direct and material impact on the financial statements. This report pertains only to our consideration of compliance with laws and regulations for the year ended September 30, 19xx. Our report on compliance with laws and regulations for the year



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**Chapter 5**  
**Financial Audits: Audit Steps**  
**and Reporting Requirements**

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ended September 30, 19xx [the prior year], is presented in GAO/AFMD-xx-xx dated \_\_\_\_\_

We conducted our audit in accordance with generally accepted government auditing standards [except as described in the following paragraph]. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

[Summarize scope limitations, if any.]

Compliance with laws and regulations applicable to the Administration is the responsibility of the Administration's management. As part of obtaining reasonable assurance as to whether the consolidated financial statements were free of material misstatement, we tested the Administration's compliance with the following provisions of laws and regulations [or as listed in an attachment]. However, our primary objective was not to provide an opinion on overall compliance with such provisions.

[List provisions tested.]

Our test results indicate that with respect to the items tested, the Administration complied, in all material respects, with the provisions referred to above. With respect to items not tested, nothing came to our attention that caused us to believe that the Administration had not complied, in all material respects, with these provisions. However, we found matters involving compliance issues meriting management's attention, and they are being reported separately to management.

Signature  
Date

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Sample  
Compliance  
Report

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Material  
Noncompliance

To the Administrator  
Federal Administration Agency

We have audited the consolidated financial statements of the Federal Administration Agency (Administration) for the fiscal year ended September 30, 19xx, and have issued our opinion thereon dated [date of opinion]. As part of our audit, we tested the Administration's compliance with certain laws and regulations which, if not followed, could have a direct and material impact on the financial statements. This report pertains only to our consideration of compliance with laws and regulations for the year ended September 30, 19xx. Our report on compliance with laws and regulations for the year ended September 30, 19xx [the prior year], is presented in GAO/AFMD-xx-xx dated \_\_\_\_\_

We conducted our audit in accordance with generally accepted government auditing standards [except as described in the following paragraph]. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

[Summarize scope limitations, if any.]

Compliance with laws and regulations applicable to the Administration is the responsibility of the Administration's management. As part of obtaining reasonable assurance as to whether the consolidated financial statements were free of material misstatement, we tested the Administration's compliance with the following provisions of laws and regulations [or as listed in an attachment]. However,

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**Chapter 5**  
**Financial Audits: Audit Steps**  
**and Reporting Requirements**

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our primary objective was not to provide an opinion on overall compliance with such provisions.

[List provisions tested.]

During our audit, we noted the following instances of noncompliance.

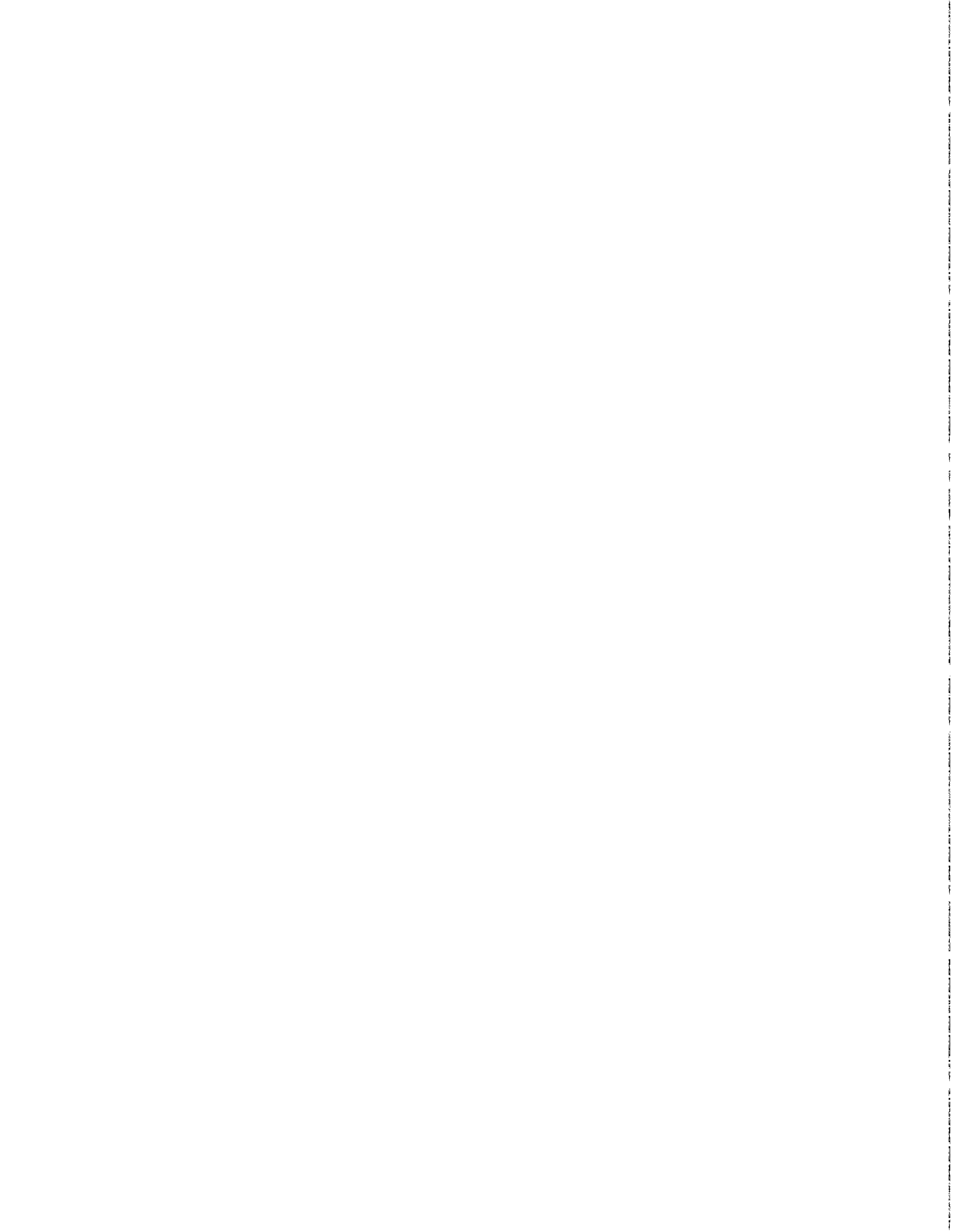
[Describe each significant instance of noncompliance and recommended corrective action. One of the recommendations should suggest that the agency report these weaknesses in its next Financial Integrity Act report.]

We considered these material instances of noncompliance in forming our opinion on whether the Administration's 19xx consolidated financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report on those consolidated financial statements.

Except as described above, the results of our tests of compliance with laws and regulations indicate that with respect to the items tested, the Administration complied, in all material respects, with the provisions referred to above. With respect to items not tested, nothing came to our attention that caused us to believe that the Administration had not complied, in all material respects, with these provisions.

We found other matters involving compliance issues meriting management's attention. They are being reported separately to management.

Signature  
Date



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