SECTION 200

Planning Phase

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210 – Overview of the Planning Phase

1. The objective of the auditor is to plan the audit so that it will be performed in an effective manner (AU-C 300.04). The auditor should develop effective and efficient ways to obtain the sufficient appropriate evidence necessary to report on the entity’s
   * + - * financial statements, required supplementary information (RSI) (including management’s discussion and analysis (MD&A)), and other information included in the annual report;
         * internal control over financial reporting;
         * financial management systems’ substantial compliance with the three requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA) (for CFO Act agencies); and
         * compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.[[1]](#footnote-2)

The nature, extent, and timing of planning vary based on factors, such as the entity’s size and complexity, the auditor’s experience with the entity, and the auditor’s knowledge of entity operations.

1. The FAM methodology overview in the contents outlines the procedures performed in the planning phase of a financial audit to develop an overall strategy for the audit. The engagement partner and other key members of the engagement team should be involved in planning the audit, including planning and participating in the discussion among engagement team members (AU-C 300.05). The engagement partner may delegate portions of the planning and supervision of the audit to other members of the team (AU-C 300.A4).
2. In the planning phase, the auditor begins performing risk assessment procedures, which continue through the internal control phase. The risk assessment procedures performed in the planning phase include obtaining an understanding of the entity’s operations and internal control, performing preliminary analytical procedures, identifying risks of material misstatement, and assessing inherent risk. The risk assessment procedures discussed in FAM 200 (Planning Phase) and FAM 300 (Internal Control Phase), which includes an assessment of control risk, collectively provide a basis for the design of further audit procedures discussed in FAM 400 (Testing Phase). Before the conclusion of the audit, the auditor evaluates, based on the audit procedures performed and audit evidence obtained, whether the assessments of the risks of material misstatement remain appropriate (see FAM 530 in the Reporting Phase).
3. The auditor should design and perform risk assessment procedures to obtain audit evidence that provides an appropriate basis for

* the identification and assessment of risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels and
* the design of further audit procedures (AU-C 315.13), consisting of control and substantive tests.

The auditor should do so in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory (AU-C 315.13).

1. Risk assessment procedures should include the following (AU-C 315.14):
   * + - * inquiries of management and of other appropriate individuals within the entity, including individuals within the internal audit function (if the function exists);
         * analytical procedures; and
         * observation and inspection.
2. In obtaining audit evidence that provides an appropriate basis for risks of material misstatement and further audit procedures, the auditor should consider information from
   * + - * the auditor’s procedures regarding acceptance or continuance of the client relationship or the audit engagement and
         * when applicable, other engagements performed by the engagement partner for the entity (AU-C 315.15).
3. The auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and that guides the development of the audit plan (AU‑C 300.07). Although concentrated in the planning phase, planning is an iterative process performed throughout the audit. For example, findings from the internal control phase directly affect planning the substantive audit procedures. Also, the results of control and substantive tests may require changes in the audit strategy or audit plan. Thus, the auditor should update and change the overall audit strategy and audit plan, as necessary, during the course of the audit (AU‑C 300.10).
4. The auditor should consider whether specialized skills are needed in performing the audit. If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills who either may be a member of the auditor’s staff or an outside professional. In such circumstances, the auditor should have sufficient knowledge to communicate the objectives of the other professional’s work; evaluate whether the specified audit procedures will meet the auditor’s objectives; and evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures (AU-C 300.12). See FAM 620 for guidance on the auditor's use of the work of specialists in an audit. The engagement team and any specialists should, collectively, have the appropriate competence and capabilities to perform the audit in accordance with GAGAS and applicable legal and regulatory requirements, and enable an auditor’s report that is appropriate in the circumstances to be issued (AU-C 220A.16).
5. The auditor should plan the nature, timing, and extent of direction and supervision of engagement team members and review of their work. The nature, timing, and extent of the direction and supervision of the engagement team members and review of their work vary, depending on many factors, including the size and complexity of the entity, the area of the audit (such as fraud and accounting estimates), the assessment of risks of material misstatement, and the capabilities and competence of the individual team members performing the work (AU-C 300.11 and AU-C 300.A18).
6. The auditor should consider the needs of, and consult in a timely manner with, other auditors who plan to use the work being performed, especially when exercising significant professional judgment.

215 – Perform Preliminary Engagement Activities

1. The auditor should undertake the following activities at the beginning of the audit (AU-C 300.06):
2. Perform procedures regarding acceptance and continuance of the client relationships and the audit engagement, as required by AU-C 220A, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.
3. Evaluate auditor’s compliance with relevant ethical requirements in accordance with AU-C 220A and *Government Auditing Standards*, chapter 1, “Foundation and Principles for the Use and Application of Government Auditing Standards.”
4. Establish an understanding of the terms of the engagement with management[[2]](#footnote-3) and, when appropriate, those charged with governance,[[3]](#footnote-4) including establishing that certain preconditions for an audit are present, as required by AU-C 210, *Terms of Engagement*.
5. In the federal environment, the client may include

* the management of the entity to be audited, including senior executives and financial managers;
* the inspector general (IG) if the IG has contracted for the audit;
* the members of a board or commission responsible for the entity;
* the audit committee; or
* a combination of these.

The auditor should identify and document who is the client and those charged with governance for each federal audit. The client and those charged with governance may include multiple entities from this list. See FAM 215.27 for additional guidance on identifying those charged with governance.

1. For most entities, the Congress (including its committees) has an oversight role, but typically it is not specifically responsible for or involved in overseeing the entity’s financial reporting process and is not considered to be part of the entity’s internal control. In these circumstances, the Congress (including its committees) is not considered to be part of those charged with governance or an oversight body for purposes of financial statement audits. Auditors should follow their audit organization’s protocols or other policies for communicating with the Congress or its committees. The auditor may decide to include some of the items listed in FAM 550.18 in the communication to the Congress or its committees, but the auditor is not required to communicate these items.
2. The auditor should communicate with management, those charged with governance, and individuals contracting for or requesting the audit. When auditors perform the audit pursuant to a law or regulation or they conduct the work for the congressional committee that has oversight of the entity, the auditor also should communicate with the congressional committee (GAGAS (2018) 6.06).
3. Audits may be conducted under various legal authorities. For example, the audit may be

* mandated by law;
* performed under an audit organization’s discretionary statutory legal authority;
* performed under contract authority to procure audit services; or
* requested by a congressional committee(s), subcommittee(s), or member(s).

Acceptance and Continuance of Client Relationships and Audit Engagements and Relevant Ethical Requirements

1. The engagement partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed (AU-C 220A.14). The audit organization establishes these procedures as part of its system of quality control (AICPA Professional Standards, Quality Control Section 10). The engagement partner should also determine that the conclusions reached in performing the procedures are appropriate (AU-C 220A.14). The following information assists the engagement partner in making this determination (AU-C 220A.A7):

* the integrity of the principal owners, key management, and those charged with governance of the entity;
* whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
* whether the audit organization and the engagement team can comply with relevant ethical requirements (AU-C 200.16); and
* significant findings or issues that have arisen during the current or previous audit engagement and their implications for continuing the relationship.

1. Relevant ethical requirements are those to which the engagement team and engagement quality control reviewer are subject. These consist of GAGAS, the AICPA *Code of Professional Conduct*, and rules of applicable state boards of accountancy and regulatory agencies (AU-C 220A.09). At the beginning of the engagement, the auditor should evaluate whether the audit organization can comply with the legal and relevant ethical requirements in performing the audit engagement (AU-C 300.06 and QC Section 10.27). Throughout the audit engagement, the engagement partner and other members of the engagement team should remain alert for evidence of noncompliance with relevant ethical requirements by members of the engagement team (AU-C 220A.11). If matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the audit organization as appropriate, should determine that appropriate action has been taken (AU‑C 220A.12).
2. The engagement partner should form a conclusion on compliance with independence requirements that apply to the audit engagement by
3. obtaining relevant information from the audit organization and, when applicable, other audit organizations to identify and evaluate circumstances and relationships that create threats to independence;
4. evaluating information on identified breaches, if any, of the audit organization’s independence policies and procedures to determine whether they create a threat to independence for the audit; and
5. taking appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards.

The engagement partner should promptly report to the audit organization any inability to resolve the matter so that the organization may take appropriate action. (AU-C 220A.13 and GAGAS (2018) 3.27)

1. In the federal environment, auditors may be appointed in accordance with law or regulation, and as such, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and audit engagements may not be relevant. Nonetheless, information gathered as a result of the process described may be valuable in planning the audit, performing risk assessments, and carrying out reporting responsibilities (AU-C 220A.A8).
2. The auditor’s consideration of client continuance and relevant ethical requirements, including independence, occurs throughout the audit engagement as conditions and changes in circumstances occur. Performing initial procedures on both client continuance and evaluation of relevant ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often begin shortly after (or in connection with) the completion of the previous audit (AU-C 300.A8).
3. Before accepting an engagement for an initial audit, including a reaudit engagement, when a predecessor auditor exists, the auditor should request that management authorize the predecessor auditor to respond fully to the auditor’s inquiries regarding matters that will assist the auditor in determining whether to accept the engagement. If management refuses to authorize the predecessor auditor to respond or limits the response, the auditor should inquire about the reasons and consider the implications of that refusal or limitation in deciding whether to accept the engagement. (AU-C 210.11) If a law or regulation requiring an audit specifically identifies the entities to be audited, in addition to management, the auditor may find it necessary to obtain authorization from those individuals contracting for or requesting the audit and from those legislative committees, if any, that have ongoing oversight responsibilities for the audited entity (AU-C 210.A36).

If management authorizes the predecessor auditor to respond to the auditor’s inquiries, the auditor should inquire of the predecessor auditor about matters that will assist the auditor in determining whether to accept the engagement, including

1. identified or suspected fraud involving
   * management,
   * employees who have significant roles in internal control, or
   * others, when the fraud resulted in a material misstatement in the financial statements and
2. matters involving noncompliance or suspected noncompliance with laws, regulations, contracts, or grant agreements that came to the predecessor auditor’s attention during the audit, other than when matters are clearly inconsequential (AU-C 210.12).

The communication with the predecessor auditor may be either written or oral (AU-C 210.A32). See AU-C 210.A32 for other matters that may be subject to the auditor’s inquiry of the predecessor auditor.

1. In determining whether to accept the engagement, the auditor should evaluate the predecessor auditor’s response or consider the implications if the predecessor auditor provides no response or a limited response (AU‑C 210.14). See AU-C 210.13 for the predecessor auditor’s responsibilities in responding to the auditor.
2. The auditor should document the following related to acceptance and continuance of clients and audit engagements and relevant ethical requirements:
3. inquiries of the predecessor auditor and the results of those inquiries, if applicable (AU-C 210.15);
4. conclusions reached regarding acceptance and continuance of the client relationship and audit engagement (AU-C 220A.25c);
5. any issues identified with respect to compliance with relevant ethical requirements and how they were resolved (AU-C 220A.25a), including any threats to independence and the safeguards applied (GAGAS (2018) 3.107a); and
6. conclusions on compliance with independence requirements that apply to the audit engagement and any relevant discussions with the audit organization that support the conclusions (AU-C 220A.25b).

Preconditions for an Audit

1. To establish whether the preconditions for an audit are present, the auditor should determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable (AU-C 210.06a). An applicable financial reporting framework (generally U.S. GAAP) provides the criteria for management to present the financial statements of an entity, including the fair presentation of those financial statements (AU-C 210.A2). The AICPA has designated the Federal Accounting Standards Advisory Board (FASAB) as the source of U.S. generally accepted accounting principles (U.S. GAAP) for federal reporting entities. Effective for periods beginning after September 30, 2017, federal reporting entities, currently defined in Statement of Federal Financial Accounting Concepts 2, will be defined in Statement of Federal Financial Accounting Standards (SFFAS) 47, *Reporting Entity*. As permitted by SFFAS 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board*, some federal entities, including government corporations, prepare financial statements in accordance with standards promulgated by the Financial Accounting Standards Board (FASB). For further information on the requirements for applying the FASB standards, see SFFAS 34.

Factors that are relevant to the auditor’s determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include the following (AU-C 210.A4):

* the nature of the entity (for example, whether it is a business enterprise, a governmental entity, or a not-for-profit organization);
* the purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users);
* the nature of the financial statements (for example, whether the financial statement are a complete set of financial statements or a single financial statement); and
* whether law or regulation prescribes the applicable financial reporting framework (generally U.S. GAAP).

1. Additionally, the auditor should obtain the agreement of management that it acknowledges and understands its responsibilities in a financial statement audit, including responsibility for
   * + - * the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework (generally U.S. GAAP);
         * the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error (AU-C 210.06b); and
         * compliance with provisions of laws, regulations, contracts, and grant agreements applicable to the entity.

The auditor should also obtain the agreement of management that it acknowledges and understands its responsibility to provide the auditor with

* + - * + access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters;
        + additional information that the auditor may request from management for the purpose of the audit; and
        + unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence (AU‑C 210.06b).

The example audit engagement letters in FAM 215 A include these and other management responsibilities.

1. Management’s agreement should be in writing and may be incorporated as part of the audit engagement letter, as shown in the examples in FAM 215 A (AU‑C 210.10 and .A44). This agreement should generally be obtained from the same officials whom the auditor will ask to sign the management representation letter.
2. If the preconditions for an audit, as discussed in FAM 215.14 through .15, are not present, the auditor should discuss the matter with management. If the preconditions for an audit have not been met, the auditor should not accept the proposed audit engagement, unless required by law or regulation to do so (AU‑C 210.08). For federal financial statement audits, executive branch departments, agencies, and other entities are required to prepare audited financial statements under such laws as the CFO Act, the Government Management Reform Act of 1994, or the Accountability of Tax Dollars Act of 2002. Government corporations are required to prepare audited financial statements under the Government Corporation Control Act.

Agreement on the Terms of the Engagement

1. The auditor should agree upon the terms of the engagement with management, those charged with governance, or both, as appropriate (AU-C 210.09). When the agreement on the terms of the engagement is only with those charged with governance, the auditor is required to obtain management’s agreement that it acknowledges and understands its responsibilities (AU-C 210.06 and .A21). The auditor should document the agreed-upon terms in an audit engagement letter or other suitable form of written agreement. The letter or written agreement should include
2. the required elements and wording in AU-C 210.10, related to the objectives and scope;
3. the responsibilities of both management and the auditor;
4. a statement that because of the inherent limitations of an audit and internal control, an unavoidable risk exists that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with GAGAS;
5. identification of the applicable financial reporting framework for the preparation of the financial statements (generally U.S. GAAP); and
6. expected form and content of reports, including a statement that circumstances may arise in which a report may differ from its expected form and content.

Additionally, the letter generally states that the auditor will conduct the audit in accordance with GAGAS, and if applicable, Office of Management and Budget (OMB) audit guidance. Those standards and OMB audit guidance require that the auditor plans and performs the audit to obtain reasonable, rather than absolute, assurance about whether financial statements are free of material misstatement. Examples of an audit engagement letter are provided in FAM 215 A.

1. At a minimum, an audit includes obtaining an understanding of internal control sufficient for planning the audit and determining the nature, timing, and extent of audit procedures to be performed. Additional procedures may be required related to testing the effectiveness of internal control if the audit is being conducted under OMB audit guidance or if the auditor is providing an opinion on the effectiveness of internal control over financial reporting. An auditor either expresses an opinion on the effectiveness of internal control over financial reporting or reports on the results of procedures performed, as discussed in FAM 580. The engagement letter or written agreement should include the auditor’s responsibilities for testing and reporting on internal control over financial reporting, including whether the auditor plans to express an opinion on the effectiveness of internal control over financial reporting or report on the results of procedures performed.
2. The engagement letter or written agreement should include the auditor’s responsibility for
   * + - 1. testing and reporting on compliance with significant provisions of laws, regulations, contracts, or grant agreements applicable to the entity and performing other limited procedures;
         2. testing and reporting on the entity’s financial management systems’ substantial compliance with the three Federal Financial Management Improvement Act of 1996 (FFMIA) requirements (for CFO Act agencies); and
         3. applying certain limited procedures to any RSI, reading other information and considering whether a material inconsistency exists between the other information and the financial statements, and reporting the results.
3. The letter may also communicate additional matters, such as the involvement of others and fee and billing arrangements, although these may be addressed in separate contractual documents.
4. The engagement letter or written agreement is designed to avoid misunderstandings between the entity to be audited, the IG if the audit is contracted out by the IG, and the auditor. Where there is a contract, an engagement letter may be unnecessary if all of the required elements in AU‑C 210.10 are included in the contract. If management is not a party to the contract, the auditor should obtain management’s agreement with the terms of the engagement, as discussed in FAM 215.18. If both an engagement letter and a contract are prepared, the information that appears in these documents should be consistent.
5. The engagement letter or written agreement may provide that if management of the entity to be audited does not agree with the terms of the audit reached between the party contracting for the audit and the auditor, as documented in the contract or engagement letter, entity management should promptly notify the auditor. If management does not agree with the terms of the audit, the auditor should promptly inform the party contracting for the audit.
6. The auditor should not agree to a change in the terms of the audit engagement when no reasonable justification for doing so exists (AU-C 210.17). If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement for which the auditor obtains a lower level of assurance, the auditor should determine whether reasonable justification for doing so exists (AU-C 210.18). If the terms of the audit engagement are changed, the auditor and management should agree on and document the new terms of the engagement in an engagement letter or other suitable form of written agreement (AU-C 210.19).
7. If the auditor concludes that no reasonable justification for a change of the terms of the audit engagement exists and is not permitted by management to continue the original audit engagement, the auditor should refer to AU-C 210.20.

Communicating with Those Charged with Governance

1. The auditor should communicate clearly with those charged with governance. Clear communication of specific matters required to be communicated is an integral part of every audit. However, the auditor is not required to perform procedures specifically to identify other significant matters to communicate with those charged with governance (AU-C 260.05a and .A3).
2. The auditor should determine the appropriate persons within the entity’s governance structure with whom to communicate (AU-C 260.07). The appropriate persons may vary depending on the matter to be communicated. When the appropriate persons with whom to communicate are not clearly identifiable, the auditor and the engaging party may need to discuss and agree on the relevant persons within the entity’s governance structure with whom the auditor will communicate (AU-C 260.A8). In situations where there is not a single individual or group that both oversees the strategic direction of the entity and the fulfillment of its accountability obligations, or in other situations where the identity of those charged with governance is not clearly evident, the auditor should document the process followed and conclusions reached for identifying appropriate individuals to receive the required auditor communications.
3. If the auditor communicates with a subgroup of those charged with governance, such as an audit committee, or with an individual, the auditor should determine whether it also needs to communicate with the governing body (AU-C 260.08). AU-C 260.A10 through .A11 outline matters to consider when making this judgment. When all of those charged with governance are involved with managing the entity, the auditor should be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity (AU-C 260.09, .A10, and .A11).
4. The auditor should communicate to those charged with governance
   1. the auditor’s responsibilities under GAGAS (see FAM 215.30 and .31);
   2. an overview of the planned scope and timing of the audit, including the significant risks identified by the auditor (see FAM 215.32);
   3. the nature of planned work and level of assurance provided related to internal control over financial reporting and compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements; and
   4. the form, timing, and expected general content of communications.

These matters may be communicated either orally or in writing. The auditor may use the engagement letter, contract, or other written communication, such as the example letter in FAM 215 B, as part of this communication (AU-C 260.10, .11, .15, and .A48). (Note: GAO auditors should use the engagement letter.)

1. The auditor should communicate with those charged with governance the auditor’s responsibilities under GAGAS, including that
2. the auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by management, with the oversight of those charged with governance, are prepared, in all material respects, in conformity with U.S. GAAP and
3. the audit of the financial statements does not relieve management or those charged with governance of their responsibilities (AU-C 260.10).

If the entity includes other information in its annual report, such as in a performance and accountability report (PAR), agency financial report (AFR), or annual management report (AMR), the auditor should communicate with those charged with governance the auditor’s responsibility with respect to such other information, the procedures performed relating to the other information, and the results (AU-C 720.15).

1. The auditor may also communicate to those charged with governance the auditor’s responsibilities that were communicated with management, as discussed in FAM 215.18 through .20. Additionally, the auditor may communicate the auditor’s responsibility for communicating significant matters as well as the limitations on this responsibility discussed in FAM 215.26 (AU-C 260.A13).
2. The auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit (AU-C 260.11). However, it is important for the auditor not to compromise the effectiveness of the audit, particularly when some or all of those charged with governance are involved with managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable. AU-C 260.A19 through .A24 provide guidance on communicating the planned scope and timing of the audit, including additional matters that the auditor may discuss with those charged with governance.

As part of communicating the planned scope and audit timing with those charged with governance, the auditor should communicate the significant risks identified by the auditor (AU-C 260.11). Such communication helps those charged with governance understand those matters and why they were determined to be significant risks. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process (AU-C 260.A20). See FAM 265.27 for a discussion of significant risks.

1. The auditor should communicate significant findings and issues from the audit to those charged with governance, as discussed in FAM 550.18 and FAM 580. This communication should be in writing if, in the auditor’s professional judgment, oral communication would not be adequate. Matters that arose during the audit that were communicated to those charged with governance and satisfactorily resolved do not need to be included in the communication. Factors that may affect whether to communicate orally or in writing, the extent of detail or summarization in the communication, and the formality of the communication are discussed in AU-C 260.A48 through .A50 (AU-C 260.12, .13, .14, and .16).
2. Management’s communication of these matters to those charged with governance does not relieve the auditor of the responsibility to also communicate with them. However, communication of these matters by management may affect the form or timing of the auditor’s communication (AU-C 260.A2).
3. The auditor’s clear communication of these matters helps establish the basis for effective two-way communication. Matters that may contribute to the effectiveness of two-way communication are included in AU-C 260.A44. As discussed in FAM 550.21, the auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit (AU-C 260.20).
4. When matters in AU-C 260, *The Auditor’s Communication With Those Charged With Governance*, discussed above are communicated in writing, the auditor should describe in the communication the purpose of the auditor’s written communication and state that the auditor’s written communication is not suitable for any other purpose (AU‑C 905.11).
5. The auditor should communicate with those charged with governance on a timely basis. AU-C 260.A51 through .A52 discuss factors relevant for determining the timing of these communications (AU-C 260.19, .A51, and .A52).
6. The auditor should document all required communications with those charged with governance. If the communication was oral, the auditor should include in the audit documentation when and to whom communication was made. If the communication was written, the auditor should retain a copy of the communication with the audit documentation. If, as part of its communication to those charged with governance, management communicated some or all of the matters the auditor is required to communicate, and as a result, the auditor did not communicate these matters at the same level of detail as management, the auditor should include a copy or summary of management’s communications provided to those charged with governance in the audit documentation (AU-C 260.21).

Intent, Notification, and Commitment Letters

1. The auditor’s internal procedures may provide for additional communication with others in the form of an intent, notification, or commitment letter, as discussed below. The auditor should send intent, notification, or commitment letters as provided by the auditor’s protocols. The engagement letter may be able to be used in place of certain of these letters.
2. An intent letter is used by some auditors to acknowledge a congressional request for any type of work. This letter may include

* acknowledgment of a meeting with congressional staff to understand the request;
* indication of a survey of work or planning phase to understand the entity, identify accounting or auditing issues, and determine the availability and access to books and records, particularly for an initial engagement;
* an estimated completion date for the planning phase;
* the auditor team performing the audit; and
* auditor contact names, phone numbers, and email addresses.

1. A notification letter is used by some auditors to notify entities of new engagements for any type of work. This letter may include

* the source of work (mandate, request, or auditor’s statutory discretionary authority);
* objective(s) of the work;
* entities and locations to be contacted;
* the estimated start date;
* the estimated date of entrance conference;
* the auditor team performing the audit;
* auditor contact names, phone numbers, and email addresses; and
* engagement (job) code or other tracking number.

1. A commitment letter is used by some auditors, either after a survey of work or the planning phase has been completed, or to confirm a commitment to perform an audit based on a congressional request, mandate, or auditor’s statutory discretionary authority for any type of work. This letter may include

* a confirmation of the auditor’s commitment to perform work and issue a report;
* an overview of the engagement approach, objective(s), and key aspects of the work, including a separate survey of work or planning phase, if conducted;
* the planned report issuance date;
* the auditor team performing the audit; and
* auditor contact names, phone numbers, and email addresses.

1. For an agreed-upon procedure engagement, as discussed in FAM 710.04, the auditor may issue an engagement letter unless covered by contract or other written communication. An example letter for agreed-upon procedure engagements is presented in FAM 710 A.

215 A – Sample Audit Engagement Letter

1. As discussed in FAM 215.18, the engagement letter documents the audit’s objectives and scope, the roles and responsibilities of both management and the auditor, and other matters. Example 1 presents a sample audit engagement letter when the auditor plans to provide an opinion on the effectiveness of an entity’s internal control. Example 2 presents a sample audit engagement letter when the auditor plans to report on the entity’s internal control and will not provide an opinion.

In both sample letters, the audited entity has a fiscal year ending September 30. The auditor should modify the sample letters, as needed, for the specific circumstances of each audit.

Example 1 – Auditor Provides an Opinion on Effectiveness of an Entity’s Internal Control over Financial Reporting

[Auditor letterhead]

**[**Date**]**

**[**Address to entity management; those charged with governance; the inspector general if the audit has been contracted out to a certified public accounting firm; or others, such as congressional committees, as appropriate.**]**

Dear \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_:

Pursuant to the [**cite legal or contract authority for audit**], the [**name of auditor**] will audit, for fiscal year [**20X2**[[4]](#footnote-5)], the financial statements of the [**full name of the entity (entity abbreviation)**]. The job code for this audit is [**XXXXXX**] [non-GAO auditors should omit or modify identifier as appropriate]*.* We confirm our acceptance and our understanding of this audit engagement by means of this letter. The objectives and scope of our integrated audits are as follows:

1. Express an opinion on whether [entity’s**]** financial statements as of and for the fiscal years ended **[**September 30, 20X2, and 20X1**]**, are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles.
2. Express an opinion on whether **[**entity**]** maintained, in all material respects, effective internal control over financial reporting as of **[**September 30, 20X2**]**, based on the criteria established under 31 U.S.C. § 3512 (c), (d), commonly known as the Federal Managers’ Financial Integrity Act of 1982 (FMFIA) **[**or other appropriate criteria**]**.
3. Report on the results of our tests of **[**entity’s**]** compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements for fiscal year **[**20X2**]**.
4. Report whether **[**entity’s**]** financial management systems comply substantially with the three requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA) as of **[**September 30, 20X2**]**. **[**If applicable**]**

Upon completion of our audit, we will issue a written report consistent with these objectives. Circumstances may arise in which our report may differ from its expected form and content based on the results of our audit. Depending on the nature of these circumstances, it may be necessary for us to modify our opinions or add emphasis-of-matter or other-matter paragraphs to our auditor’s report.

The purpose of our report[s] on compliance with laws, regulations, contracts, and grant agreements **[**and financial management systems’ substantial compliance with FFMIA requirements, if applicable**]** solely will be to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements **[**and financial management systems’ substantial compliance with FFMIA requirements, if applicable**]**, and the results of that testing, and not to provide an opinion on compliance with applicable laws, regulations, contracts, and grant agreements **[**or on financial management systems’ substantial compliance with FFMIA requirements, if applicable**]**. Accordingly, our report[s] on compliance with laws, regulations, contracts, and grant agreements **[**and financial management systems’ substantial compliance with FFMIA requirements, if applicable**]** will not be suitable for any other purpose.

**[**Modify the previous paragraph, as shown, if the auditor is engaged to provide an opinion on compliance with applicable laws, regulations, contracts, and grant agreements, or on the entity’s financial management systems’ substantial compliance with FFMIA.**]**

Management’s Responsibilities

Our audit will be conducted on the basis that **[**entity’s**]** managementacknowledges and understands that it has responsibility for the following:

1. The preparation and fair presentation of **[**entity’s**]** financial statements, including related notes, in accordance with U.S. generally accepted accounting principles.
2. Designing, implementing, and maintaining effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
3. Assessing the effectiveness of **[**entity’s**]** internal control over financial reporting based on the criteria established under FMFIA **[**or other appropriate criteria**]**.
4. Its assessment about the effectiveness of internal control over financial reporting as of **[**September 30, 20X2**]**. This includes providing management’s written representation that it did not use the auditor’s procedures performed during the integrated audits as part of the basis for its assessment about the effectiveness of **[**entity’s**]** internal control over financial reporting.
5. Supporting its assessment about the effectiveness of **[entity’s]** internal control over financial reporting with sufficient evaluations and documentation.
6. Complying with laws, regulations, contracts, and grant agreements applicable to [entity].
7. Preparing, measuring, and presenting the required supplementary information (RSI) in accordance with prescribed guidelines established in U.S. generally accepted accounting principles.
8. Preparing and presenting other information included in **[entity’s]** **[insert name of annual report, e.g., agency financial report]**, and ensuring the consistency of that information with the audited financial statements and RSI.
9. Designing, implementing, and maintaining effective internal controls to prevent and detect fraud. This includes providing management’s written representation that it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
10. Maintaining adequate accounting records, selecting and applying appropriate accounting policies, and safeguarding U.S. government assets related to **[**entity’s**]** operations.
11. **[For entities that conform to FASB standards (see FAM 550.31 and .32)]** Evaluating whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity’s]** ability to continue as a going concern for a reasonable period of time.
12. Ensuring that **[**entity’s**]** financial management systems comply substantially with FFMIA requirements **[if applicable]**.

In addition, **[**entity’s**]** managementacknowledges and understands that it has the responsibility to provide us with

1. access to all information, such as records, documentation, and other matters, of which management is aware that is relevant to the (1) preparation and fair presentation of the financial statements, including related notes; (2) measurement, preparation, and presentation of the RSI; and (3) preparation and presentation of other information;
2. additional information that we may request from management for the purpose of the audit, including but not limited to
   1. minutes of meetings, or summaries of actions of recent meetings for which minutes have not been prepared, of the **[Board of Directors or other similar bodies of those charged with governance]** and
   2. any communications from the Office of Management and Budget (OMB) or the Department of the Treasury’s Bureau of the Fiscal Service concerning noncompliance with, or deficiencies in, financial reporting practices;
3. unrestricted access to and full cooperation of personnel within **[entity]** from whom we determine it necessary to obtain audit evidence; and
4. any reports obtained from **[entity]**’s service organizations.

**[**Entity**]** management agrees to communicate to us

1. the discovery of any material misstatement that would affect the fair presentation of its fiscal year **[**20X2**]** or prior fiscal year’s financial statements;
2. any deficiencies in the design or operation of internal control over financial reporting as of **[**September 30, 20X2**]**, including separately identifying any deficiencies management believes to be significant deficiencies or material weaknesses;[[5]](#footnote-6)
3. a description of fraud or suspected fraud that affects **[entity]** and involves (1) management, (2) employees who have significant roles in internal control over financial reporting, or (3) others when the fraud could have a material effect on the financial statements;
4. any instances of noncompliance or suspected noncompliance with laws, regulations, contracts, and grant agreements applicable to **[entity]** whose effects should be considered when preparing the financial statements;
5. any violations, or potential violations, of the Antideficiency Act for the years ended **[**September 30, 20X2, and 20X1**]** and through the date of the management representation letter. Potential violations are limited to those that, if true, could have a material effect on the financial statements;
6. any known actual or possible litigation, claims, and assessments, including those related to treaties and other international agreements, whose effects should be considered when preparing the financial statements;
7. the identities of **[entity’s]** disclosure entities, related parties, and public-private partnerships, and all the relationships and transactions related to them;[[6]](#footnote-7)
8. any events or transactions subsequent to the date of the financial statements, and for which U.S. generally accepted accounting principles require adjustment or disclosure;
9. whether, subsequent to **[September 30, 20X2]**, there were any changes in internal control over financial reporting or other conditions that might significantly affect internal control over financial reporting, including any corrective actions taken with regard to material weaknesses or significant deficiencies; and
10. any planned inclusion of our auditor’s reports and the audited financial statements in documents prepared by [entity] and to provide a copy of any such documents prior to issuance.

As part of our audit process, we will request from [entity] management written confirmation concerning representations made to us in connection with the audit of the financial statements, including internal control over financial reporting; compliance with applicable laws, regulations, contracts, and grant agreements; and other related matters.

[Optional – The auditor may choose to make management aware of other specific required written management representations. Factors to consider include initial audits, changes in senior management, or changes in required representations.]

Definition and Inherent Limitations of Internal Control over Financial Reporting

An entity’s internal control over financial reporting is a process effected by those charged with governance, management, and other personnel. The objectives of internal control over financial reporting are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition, and (2) transactions are executed in accordance with provisions of applicable laws, including those governing the use of budget authority, regulations, contracts, and grant agreements, noncompliance with which could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements due to fraud or error. We also caution that projecting any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Auditor’s Responsibilities

We are responsible for conducting our audits in accordance with U.S. generally accepted government auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether (1) the financial statements as a whole are free from material misstatement, whether due to fraud or error, and (2) effective internal control over financial reporting was maintained in all material respects. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit of the financial statements or an audit of internal control over financial reporting conducted in accordance with U.S. generally accepted government auditing standards will always detect a material misstatement or a material weakness when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.[[7]](#footnote-8)

We are required to be independent of **[entity]** and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits.

In performing an audit of the financial statements and an audit of internal control over financial reporting in accordance with U.S. generally accepted government auditing standards, we will do the following:

1. Exercise professional judgment and maintain professional skepticism throughout the audits.
2. Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements in order to obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.
3. Obtain an understanding of internal control relevant to the financial statement audit in order to design audit procedures that are appropriate in the circumstances.
4. Obtain an understanding of internal control over financial reporting relevant to the audit of internal control over financial reporting, assess the risks that a material weakness exists, and test and evaluate the design and operating effectiveness of internal control over financial reporting based on the assessed risk. Our audit of internal control will also consider **[entity’s]** process for evaluating and reporting on internal control over financial reporting based on criteria established under FMFIA **[or other appropriate criteria]**. We will not evaluate all internal controls relevant to operating objectives as broadly established under FMFIA **[or other appropriate criteria]**, such as those controls relevant to preparing performance information and ensuring efficient operations. We will limit our internal control testing to testing controls over financial reporting. Our internal control testing will be for the purpose of expressing an opinion on whether effective internal control over financial reporting was maintained, in all material respects, as of **[September 30, 20X2]**. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness.
5. Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
6. Perform other procedures we consider necessary in the circumstances.
7. **[For entities that conform to FASB standards (see FAM 550.31 and .32)]** Conclude, based on the audit evidence obtained, whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity’s]** ability to continue as a going concern for a reasonable period of time.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk exists that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with U.S. generally accepted government auditing standards.

We will communicate all deficiencies of which we become aware. We are responsible for communicating in writing to those charged with governance any significant deficiencies and material weaknesses in internal control that come to our attention as a result of the audit. If we identify deficiencies in **[**entity’s**]** internal control that we do not consider to be material weaknesses or significant deficiencies, we will communicate these matters in writing to management and, where appropriate, will report on them separately.

In accordance with U.S. generally accepted government auditing standards, we are responsible for testing compliance with selected provisions of laws, regulations, contracts, and grant agreements applicable to [entity] that have a direct effect on the determination of material amounts in **[**entity’s**]** financial statements and performing certain other limited procedures as part of our audits.[[8]](#footnote-9) We will not test compliance with all laws, regulations, contracts, and grant agreements applicable to **[**entity**]**. We caution that noncompliance may occur and not be detected by these tests.

We are also responsible for (1) testing and reporting on whether **[**entity’s**]** financial management systems comply substantially with the three FFMIA requirements **[**if applicable**]** and (2) applying certain limited procedures to any RSI, reading other information included in **[entity’s]** **[insert name of annual report, e.g., agency financial report]** and considering whether a material inconsistency exists between the other information and the financial statements, and reporting the results.

Audit Coordination and Other Matters

To use audit resources efficiently and expedite audit completion, we will work with **[**entity**]** staff to obtain information needed for the audit. Assistance needed from **[entity]** staff may include preparing schedules or analyses; locating, copying, and providing selected documents; and participating in meetings. We will need draft financial statements, including all information relevant to their preparation and fair presentation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation and fair presentation of note disclosures), and any other information to be included in **[entity’s] [insert name of annual report, e.g., agency financial report]** in sufficient time for us to complete our audit in accordance with the proposed timetable. We will discuss this assistance with **[**entity**]** staff and arrive at mutually acceptable time frames.

We will conduct an entrance conference with [entity] staff on [or by] [date]. We plan to issue our report on a mutually agreed-upon date. [**Insert any additional details as appropriate regarding report timing.**] We will also provide periodic status reports on our work upon your request. If we encounter problems that will affect the reporting date, we will discuss them with you in a timely manner. We look forward to working with [**entity**] and appreciate its cooperation in working with us to complete the audit in a timely manner.

Pursuant to **[**include reference to audit reimbursement authority**]**, our audit of **[**entity**]** is performed on a reimbursable basis. The total cost to perform the fiscal year **[**20X2**]** audit will depend on the nature of the issues we identify and the amount of staff resources needed to complete the audit. **[**Consider including additional details as appropriate for any contracted services to be reimbursed, such as those for information systems controls or specialists.**]** We plan to submit a bill to you each month reflecting the actual costs incurred.

This assignment will be conducted under my direction, with assistance from **[**name and title of manager**]**, who can be reached at **[**phone number**]** or by email at **[**email**]**, and **[**name and title of site auditor**]**, who can be reached at **[phone number]** or by email at **[**email**]**.

The attached acknowledgment page should be signed by management **[and the addressee, if contracting party is other than management]** and returned to us to indicate your acknowledgment of, and agreement with, the terms and arrangements of our audit of the financial statements and to indicate management’s acknowledgment and understanding of our respective responsibilities.

Should this letter not represent your understanding of the nature of this engagement, or should you have any questions or need further information, please contact me at **[**phone number**]** or by email at **[**email**]**.

We look forward to a successful engagement.

Sincerely,

**[**Auditor’s name and title**]**

cc: CFO of [entity]

Inspector General of [entity]

**[Others, as applicable]**

**Management’s Acknowledgment of the Audit Engagement Terms**

On behalf of **[entity]** and its management, I acknowledge and agree to the (1) terms and arrangements described above for the audit of **[entity]**’s financial statements, including our respective responsibilities, and (2) auditor’s scope of work and related reporting on **[entity]**’s

* + - financial statements, required supplementary information (including management’s discussion and analysis) **[omit if not applicable]**, and other information to be included in **[entity’s]** **[insert name of annual report, e.g., agency financial report] [omit if not applicable]**;
    - internal control over financial reporting;
    - financial management systems’ substantial compliance with the three requirements of the Federal Financial Management Improvement Act of 1996 **[omit if not applicable]**; and
    - compliance with laws, regulations, contracts, and grant agreements.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Signature Date

**[Name and Title]**

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Signature Date

**[Name and Title]**

**[NOTE: REQUIRED TO BE SIGNED BY MANAGEMENT. SIGNERS SHOULD GENERALLY BE THE SAME OFFICIALS WHOM THE AUDITOR WILL REQUEST SIGN THE MANAGEMENT REPRESENTATION LETTER. MAY INCLUDE ADDITIONAL PARTIES INVOLVED WITH CONTRACTING FOR THE AUDIT.]**

Example 2 – Auditor Does Not Provide an Opinion on Entity’s Internal Control over Financial Reporting

**[Auditor letterhead]**

**[**Date**]**

**[Address to entity management; those charged with governance; the inspector general if the audit has been contracted out to a certified public accounting firm; or others, such as congressional committees, as appropriate.]**

Dear \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_:

Pursuant to the **[**cite legal or contract authority for audit**]**, the **[**name of auditor**]** will audit, for fiscal year **[**20X2**[[9]](#footnote-10)]**, the financial statements of the **[**full name of the entity (entity abbreviation)**]**. The job code for this audit is **[**XXXXXX**] [non-GAO auditors should omit or modify identifier as appropriate]***.* We confirm our acceptance and our understanding of this audit engagement by means of this letter. The objectives and scope of our audits are as follows:

1. Express an opinion on whether **[**entity]’s financial statements as of and for the fiscal years ended **[**September 30, 20X2, and 20X1**]**, are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles.
2. Report any significant deficiencies and material weaknesses in internal control over financial reporting for fiscal year **[**20X2**]** that come to our attention as a result of the audit.[[10]](#footnote-11)
3. Report on the results of our tests of **[**entity’s**]** compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements for fiscal year **[**20X2**]**.
4. Report whether **[**entity’s**]** financial management systems comply substantially with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA) as of **[**September 30, 20X2**]**. **[**If applicable.**]**

Upon completion of our audit, we will issue a written report consistent with these objectives. Circumstances may arise in which our report may differ from its expected form and content based on the results of our audit. Depending on the nature of these circumstances, it may be necessary for us to modify our opinion or add emphasis-of-matter or other-matter paragraphs to our auditor’s report.

The purpose of our report**[**s**]** on internal control and compliance with laws, regulations, contracts, and grant agreements **[**and financial management systems’ substantial compliance with FFMIA requirements, if applicable**]** solely will be to describe the scope of our testing of internal control and compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements **[**and FFMIA requirements, if applicable**]**, and the results of that testing, and not to provide an opinion on the effectiveness of internal control over financial reporting or compliance with applicable laws, regulations, contracts, and grant agreements **[**or on financial management systems’ substantial compliance with FFMIA requirements, if applicable**]**. Accordingly, our report**[**s**]** on internal control and compliance with laws, regulations, contracts, and grant agreements **[**and financial management systems’ substantial compliance with FFMIA requirements, if applicable**]** will not be suitable for any other purpose.

**[**Modify the previous paragraph, as shown, if the auditor is engaged to provide an opinion on compliance with applicable laws, regulations, contracts, and grant agreements, or on the entity’s financial management systems’ substantial compliance with FFMIA.**]**

**Management’s Responsibilities**

Our audit will be conducted on the basis that **[**entity’s**]** managementacknowledges and understands that it has responsibility for the following:

1. The preparation and fair presentation of **[**entity’s**]** financial statements, including related notes, in accordance with U.S. generally accepted accounting principles.
2. Designing, implementing, and maintaining effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
3. Complying with laws, regulations, contracts, and grant agreements applicable to [entity].
4. Preparing, measuring, and presenting the required supplementary information (RSI) in accordance with prescribed guidelines established in U.S. generally accepted accounting principles.
5. Preparing and presenting other information included in **[entity’s] [insert name of annual report, e.g., agency financial report]**, and ensuring the consistency of that information with the audited financial statements and the RSI.
6. Designing, implementing, and maintaining effective internal controls to prevent and detect fraud. This includes providing management’s written representation that it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
7. Maintaining adequate accounting records, selecting and applying appropriate accounting policies, and safeguarding U.S. government assets related to **[**entity’s**]** operations.
8. **[For entities that conform to FASB standards (see FAM 550.31 and .32)]** Evaluating whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity’s]** ability to continue as a going concern for a reasonable period of time.
9. Ensuring that **[**entity’s**]** financial management systems comply substantially with FFMIA requirements **[if applicable]**.

In addition, **[**entity]’s managementacknowledges and understands that it has the responsibility to provide us with

1. access to all information, such as records, documentation, and other matters, of which management is aware that is relevant to the (1) preparation and fair presentation of the financial statements, including related notes; (2) measurement, preparation, and presentation of the RSI; and (3) preparation and presentation of other information;
2. additional information that we may request from management for the purpose of the audit, including but not limited to
   1. minutes of meetings, or summaries of actions of recent meetings for which minutes have not been prepared, of the **[Board of Directors or other similar bodies of those charged with governance]** and
   2. any communications from the Office of Management and Budget (OMB) or the Department of the Treasury’s Bureau of the Fiscal Service concerning noncompliance with, or deficiencies in, financial reporting practices;
3. unrestricted access to and full cooperation of personnel within **[entity]** from whom we determine it necessary to obtain audit evidence; and
4. any reports obtained from **[entity]**’s service organizations.

**[**Entity**]** management agrees to communicate to us the following:

1. the discovery of any material misstatement that would affect the fair presentation of its fiscal year **[**20X2**]** or prior fiscal year’s financial statements;
2. any deficiencies in the design or operation of internal control over financial reporting as of **[**September 30, 20X2**]**, including separately identifying any deficiencies management believes to be significant deficiencies or material weaknesses;
3. a description of fraud or suspected fraud that affects **[entity]** and involves (1) management; (2) employees who have significant roles in internal control over financial reporting, or (3) others when the fraud could have a material effect on the financial statements;
4. any instances of noncompliance or suspected noncompliance with laws, regulations, contracts, and grant agreements applicable to **[entity]** whose effects should be considered when preparing the financial statements;
5. any violations, or potential violations, of the Antideficiency Act for the years ended **[**September 30, 20X2, and 20X1**]** and through the date of the management representation letter. Potential violations are limited to those that, if true, could have a material effect on the financial statements;
6. any known actual or possible litigation, claims, and assessments, including those related to treaties and other international agreements, whose effects should be considered when preparing the financial statements;
7. the identities of **[entity’s]** disclosure entities, related parties, and public-private partnerships, and all the relationships and transactions related to them;[[11]](#footnote-12)
8. any events or transactions subsequent to the date of the financial statements, and for which U.S. generally accepted accounting principles require adjustment or disclosure;
9. whether, subsequent to **[September 30, 20X2]**, there were any changes in internal control over financial reporting or other conditions that might significantly affect internal control over financial reporting, including any corrective actions taken with regard to material weaknesses or significant deficiencies; and
10. any planned inclusion of our auditor’s reports and the audited financial statements in documents prepared by [entity] and to provide a copy of any such documents prior to issuance.

As part of our audit process, we will request from **[entity]** management written confirmation concerning representations made to us in connection with the audit of the financial statements, including internal control over financial reporting; compliance with applicable laws, regulations, contracts, and grant agreements; and other related matters.

**[Optional – The auditor may choose to make management aware of other specific required written management representations. Factors to consider include initial audits, changes in senior management, or changes in required representations.]**

**Definition and Limitations of Internal Control over Financial Reporting**

An entity’s internal control over financial reporting is a process effected by those charged with governance, management, and other personnel. The objectives of internal control over financial reporting are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition, and (2) transactions are executed in accordance with provisions of applicable laws, including those governing the use of budget authority, regulations, contracts, and grant agreements, noncompliance with which could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements due to fraud or error.

**Auditor’s Responsibilities**

We are responsible for conducting our audit in accordance with U.S. generally accepted government auditing standards [and OMB audit guidance, if applicable]. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to error or fraud. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit of the financial statements conducted in accordance with U.S. generally accepted government auditing standards will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.[[12]](#footnote-13)

We are required to be independent of **[entity]** and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits.

In performing an audit of the financial statements in accordance with U.S. generally accepted government auditing standards, we will do the following:

1. Exercise professional judgment and maintain professional skepticism throughout the audits.
2. Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements in order to obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.
3. Obtain an understanding of internal control relevant to the financial statement audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. In addition, we will not consider all internal controls relevant to operating objectives as broadly established under 31 U.S.C. § 3512 (c), (d), commonly known as the Federal Managers’ Financial Integrity Act of 1982 (FMFIA) **[or other appropriate criteria]**, such as those controls relevant to preparing performance information and ensuring efficient operations. Our internal control work will not necessarily identify all deficiencies in internal control, including those that might be material weaknesses or significant deficiencies.
4. Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
5. Perform other procedures we consider necessary in the circumstances.
6. **[For entities that conform to FASB standards (see FAM 550.31 and .32)]** Conclude, based on the audit evidence obtained, whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity’s]** ability to continue as a going concern for a reasonable period of time.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk exists that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with U.S. generally accepted government auditing standards.

We will communicate all deficiencies in internal control of which we become aware. We are responsible for communicating in writing to those charged with governance any significant deficiencies and material weaknesses in internal control that come to our attention as a result of the audit. Additionally, if we do not identify any material weaknesses during our audit, we will indicate this in our written communication.[[13]](#footnote-14) If we identify deficiencies in **[**entity]’s internal control that we do not consider to be material weaknesses or significant deficiencies, we will communicate these matters in writing to management and, where appropriate, will report on them separately. In addition, if we identify misstatements or new deficiencies, we will communicate them to **[entity]** management on a timely basis.

In accordance with U.S. generally accepted government auditing standards, we are responsible for testing compliance with selected provisions of laws, regulations, contracts, and grant agreements applicable to [entity] that have a direct effect on the determination of material amounts in **[**entity]’s financial statements and performing certain other limited procedures as part of our audit. We will not test compliance with all laws, regulations, contracts, and grant agreements applicable to **[**entity**]**. We caution that noncompliance may occur and not be detected by these tests.

We are also responsible for (1) testing and reporting on whether **[**entity]’s financial management systems comply substantially with the three FFMIA requirements **[**if applicable**]** and (2) applying certain limited procedures to any RSI, reading other information included in **[entity’s]** **[insert name of annual report, e.g., agency financial report]** and considering whether a material inconsistency exists between the other information and the financial statements, and reporting the results.

**Audit Coordination and Other Matters**

To use audit resources efficiently and expedite audit completion, we will work with **[**entity**]** staff to obtain information needed for the audit. Assistance needed from **[**entity**]** staff may include preparing schedules or analyses; locating, copying, and providing selected documents; and participating in meetings. We will need draft financial statements, including all information relevant to their preparation and fair presentation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation and fair presentation of note disclosures), and any other information to be included in **[entity’s]** **[insert name of annual report, e.g., agency financial report]** in sufficient time for us to complete our audit in accordance with the proposed timetable. We will discuss this assistance with **[**entity**]** staff and arrive at mutually acceptable time frames.

We will conduct an entrance conference with **[**entity**]** staff on **[**or by**]** **[**date**]**. We plan to issue our report on a mutually agreed-upon date. **[**Insert any additional details as appropriate regarding report timing.**]** We will also provide periodic status reports on our work upon your request. If we encounter problems that will affect the reporting date, we will discuss them with you in a timely manner. We look forward to working with [entity] and appreciate its cooperation in working with us to complete the audit in a timely manner.

Pursuant to **[**include reference to audit reimbursement authority**]**, our audit of **[**entity**]** is performed on a reimbursable basis. The total cost to perform the fiscal year **[**20X2**]** audit will depend on the nature of the issues we identify and the amount of staff resources needed to complete the audit. **[**Consider including additional details as appropriate for any contracted services to be reimbursed, such as those for information systems controls or specialists.**]** We plan to submit a bill to you each month reflecting the actual costs incurred.

This assignment will be conducted under my direction, with assistance from **[**name and title of manager**]**, who can be reached at **[**phone number**]** or by email at **[**email**]**, and **[**name and title of site auditor**]**, who can be reached at **[phone number]** or by email at **[**email**]**.

The attached acknowledgment page should be signed by management **[and the addressee, if contracting party is other than management]** and returned to us to indicate your acknowledgment of, and agreement with, the terms and arrangements of our audit of the financial statements and to indicate management’s acknowledgment and understanding of our respective responsibilities.

Should this letter not represent your understanding of the nature of this engagement, or should you have any questions or need further information, please contact me at **[**phone number**]** or by email at **[**email**]**.

We look forward to a successful engagement.

Sincerely,

**[**Auditor’s name and title**]**

cc: CFO of **[entity]**   
 Inspector General of **[entity]** **[Others, as applicable]**

**Management’s Acknowledgment of the Audit Engagement Terms**

On behalf of **[entity]** and its management, I acknowledge and agree to the (1) terms and arrangements described above for the audit of **[entity]**’s financial statements, including our respective responsibilities, and (2) auditor’s scope of work and related reporting on **[entity]**’s

* financial statements, required supplementary information (including management’s discussion and analysis) **[omit if not applicable]**, and other information to be included in **[entity’s]** **[insert name of annual report, e.g., agency financial report] [omit if not applicable]**;
* internal control over financial reporting;
* financial management systems’ substantial compliance with the three requirements of the Federal Financial Management Improvement Act of 1996 **[omit if not applicable]**; and
* compliance with laws, regulations, contracts, and grant agreements.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Signature Date

**[Name and Title]**

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Signature Date

**[Name and Title]**

**[NOTE: REQUIRED TO BE SIGNED BY MANAGEMENT. SIGNERS SHOULD GENERALLY BE THE SAME OFFICIALS WHOM THE AUDITOR WILL REQUEST SIGN THE MANAGEMENT REPRESENTATION LETTER. MAY INCLUDE ADDITIONAL PARTIES INVOLVED WITH CONTRACTING FOR THE AUDIT.]**

215 B – Sample Letter to Those Charged with Governance

**[Auditor letterhead]**

**[Date]**

**[Address to board or commission responsible for the entity, an audit committee, secretary of a cabinet-level department, senior executives and financial managers, or congressional committees in their role as those charged with governance.]**

Dear \_\_\_\_\_\_\_\_\_\_\_\_\_:

This letter is to inform you that we will soon begin **[or have recently begun]** our audit of the fiscal year 20X2 financial statements of the **[full name of the entity (entity abbreviation)]**. We **[held or will hold]** an entrance conference with officials of **[entity]** on **[date]**.

**[If mandated:]** We are responsible for conducting audits of the financial statements of **[entity]** in accordance with **[cite legal or contract authority]**. **[If requested:]** As requested in your letter of **[date] [or as discussed with your staff]**, we will conduct an audit of financial statements of **[entity]**. **[If auditor’s statutory authority:]** Under our audit authority **[cite legal or contract authority]**, we will conduct an audit of financial statements of **[entity]**. We plan to issue our report by **[date]**.

A copy of our **[date]** audit engagement letter to **[entity or inspector general]** is attached.[[14]](#footnote-15) This letter explains the nature of the engagement, our responsibilities as auditors, and the responsibilities of **[entity]** management.

We will provide periodic status reports on our work upon your request. We will also notify you when we will provide a draft report to **[entity]** for comment and can provide a copy to you for informational purposes upon your request. Should this letter and the attached engagement letter not represent your understanding of the nature of this engagement, or should you have any questions, please contact me at **[phone number]** or by email at **[address]**, or **[second auditor contact and title]**, at **[phone number]** or by email at **[address]**.

Sincerely,

**[Auditor name and title]**

Enclosure

220 – Understand the Entity’s Operations

1. Understanding the entity’s operations in the planning process enables the auditor to identify, assess, and respond to the risks of material misstatement due to fraud or error and to resolve accounting and auditing problems early in the audit. The auditor should perform risk assessment procedures to obtain an understanding of
2. the following aspects of the entity and its environment:

* the entity’s organizational structure, governance, and activities, including the extent to which the entity’s activities integrate the use of information technology;
* industry, regulatory, and other external factors; and
* the measures used, internally and externally, to assess the entity’s financial performance (AU-C 315.19a);

1. the applicable financial reporting framework (generally U.S. GAAP) and the entity’s accounting policies and the reasons for any changes thereto (AU-C 315.19b);
2. how inherent risk factors affect the susceptibility of assertions to misstatements, and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework (generally U.S. GAAP), based on the understanding obtained in items a and b above (AU-C 315.19c);[[15]](#footnote-16)
3. the legal and regulatory framework applicable to the entity and how the entity is complying with that framework (AU-C 250.12);
4. the entity’s use of accounting estimates (AU-C 540.12); and
5. the entity’s relationships and transactions with disclosure entities, related parties, and public-private partnerships (AU-C 550.12).[[16]](#footnote-17)

Entity and Its Environment

1. The auditor should obtain an understanding of the entity for purposes of planning the audit. Elements include

* origin and history of the entity;
* mission and strategic goals of the entity;
* size and locations of the entity;
* organizational structure of the entity (centralized or decentralized);
* how the entity is financed;
* key members of management;
* the complexity of operations;
* the entity’s information technology environment, as discussed in FAM 260, and how it affects the generation of financial statements and the RSI in the annual PAR or AFR; and
* use of service organizations (see FAM 310.11 and FAM 640 for further details on service organizations).

See AU-C 315.A64 through .A90 for additional guidance on obtaining an understanding of the entity and its environment.

1. The auditor should identify significant internal and external factors that affect the entity’s operations.

Internal factors may include

* information technology structure, including the extent to which information system processing is performed externally by a service organization;
* increased workload from new or expanding programs;
* qualifications and competence of key personnel; and
* turnover of key personnel.

External factors may include

* source(s) of funds;
* seasonal fluctuations;
* current political climate; and
* other external factors as discussed in AU-C 315.A82, such as general economic conditions, interest rates, and inflation.

Applicable Financial Reporting Framework and the Entity’s Accounting Policies

1. The auditor should evaluate whether the entity’s accounting policies are appropriate and consistent with the applicable financial reporting framework (generally U.S. GAAP) (AU-C 315.20). An understanding of the entity’s selection and application of accounting policies, including any changes thereto as well as the reasons therefor, may encompass such matters as financial reporting standards and laws and regulations that are new to the entity and how the entity will adopt, or comply with, such requirements (AU-C 315.A91).
2. The auditor should determine whether the entity is required to report any unaudited RSI. This includes information on

* the condition of heritage assets and stewardship land,
* deferred maintenance of federal property, and
* social insurance programs.

See AU-C 315.A91 through .A93 for additional guidance on obtaining an understanding of the applicable financial reporting framework (generally U.S. GAAP) and the entity’s accounting policies.

Inherent Risk Factors

1. Inherent risk factors may affect the susceptibility of assertions to misstatement by influencing the likelihood of occurrence of a misstatement or the magnitude of the misstatement if it were to occur (AU-C 315.A95). Inherent risk factors are characteristics of events or conditions that affect the susceptibility of an assertion to misstatement, whether due to fraud or error, before consideration of control activities.[[17]](#footnote-18) Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, susceptibility to noncompliance, or susceptibility to misstatement due to management bias or other fraud risk factors (AU-C 315.12). Fraud risk factors are discussed in FAM 265.
2. The inherent risk factors discussed below are general in nature and require the auditor’s judgment in determining how they affect the auditor’s assessment of risks of material misstatement at the assertion level. Because this risk consideration requires auditors to exercise significant audit judgment, it should be performed by experienced audit personnel.

Inherent risk factors incorporate characteristics of an entity, a transaction, an account, or an assertion that exist because of the

* nature of the entity’s programs,
* prior history of audit adjustments, or
* nature of material transactions and accounts.

1. For each category listed below, FAM 295 A lists characteristics of events or conditions that may affect the susceptibility of assertions to misstatement (i.e., potential inherent risk factors).
2. **Nature of the entity’s programs:** The mission or business of an entity includes the implementation of various programs or services. The characteristics of these programs or services affect the entity’s susceptibility to errors and fraud and sensitivity to changes in economic conditions. For example, student loan guarantee programs may be more susceptible to errors and fraud because of loans that third parties issue and service.
3. **Prior history of significant audit adjustments:** Significant audit adjustments identified in previous financial statement audits or other audits often indicate conditions that may allow misstatements to occur. For example, the prior year’s audit may have identified the necessity for recording a liability as the result of certain economic conditions. The auditor could then focus on determining whether similar conditions continue to exist.
4. **Nature of material transactions and accounts:** The nature of an entity’s transactions and accounts has a direct relation to inherent risk. For example, accounts involving subjective management judgments, such as loss allowances, are usually of higher inherent risk than those involving more objective determinations.
5. Other inherent risk factors that affect susceptibility of an assertion to misstatement about a line item, account, note disclosure, or class of transactions may include one or both of the following (AU-C 315.A11):[[18]](#footnote-19)

* the quantitative or qualitative significance of the line item, account, note disclosure, or class of transactions and
* the volume or lack of uniformity in the composition of the items to be processed through the class of transactions or account balance or to be reflected in the note disclosure.

See AU-C 315.A275 for additional guidance on inherent risk factors. See AU-C 540.A152 for discussion of inherent risk factors related specifically to accounting estimates.

1. The auditor may evaluate the implications of these risk factors on related operations controls. For example, inherent risk may be associated with a material liability for loan guarantees because it is subject to significant management judgment. Because of this inherent risk factor, the entity should have strong operations controls to monitor its exposure to losses from loan guarantees. Potential deficiencies in such operations controls could significantly affect the ultimate program cost. Therefore, the auditor may identify operations control deficiencies, including the need for operations controls in a particular area that may be further evaluated, as discussed in FAM 275.
2. The entity’s information system is a discrete set of information resources organized for the collection, processing, maintenance, use, sharing, dissemination, or disposition of information. Information systems often involve **information system processing**, which is performed through the use of information technology. Information system processing (or lack thereof) can introduce inherent risk factors not present in a manual financial management system.
3. The auditor should consider each of the following factors and assess the overall impact of information system processing on inherent risk. The impact of these factors typically would be pervasive in nature and may affect the identification and assessment of risks of material misstatement at the financial statement level. An information system controls auditor (IS controls auditor) may assist the auditor in considering these factors and making this assessment. More detail on assessing risks related to information system processing and related controls is available in FISCAM, and a flowchart of steps is included in FAM 295 J.
4. **Uniform processing of transactions.** Because information systems process groups of identical transactions consistently, any misstatements arising from erroneous computer programming will occur consistently in similar transactions. However, the possibility of random processing errors is reduced substantially with information system processing.
5. **Automatic processing.** The information system may automatically initiate transactions or perform processing functions. Evidence of these processing steps (and any related controls) may or may not be visible.
6. **Increased potential for undetected misstatements.** Computers use and store information in electronic form and require less human involvement in processing. This increases the potential for individuals to gain unauthorized access to sensitive information and to alter data without visible evidence. Because of the electronic form, changes to software programs and data may not be readily detectible. Also, users may be less likely to challenge the reliability of computer output than manual reports. As such, management should evaluate security threats, which can be from internal or external sources. External threats are particularly important for entities that depend on telecommunications networks and the internet. Internal threats may come from former or disgruntled employees (Green Book 11.13).[[19]](#footnote-20)
7. **Existence, completeness, and volume of the audit trail.** The audit trail is the evidence that demonstrates how a specific transaction was initiated, processed, recorded, and summarized. For example, the audit trail for a purchase could include a purchase order; a receiving report; an invoice; an invoice register (purchases summarized by day, month, account, or a combination of these); and general ledger postings from the invoice register. Some financial management systems are designed so that the audit trail exists for only a short period (such as in online systems), only in an electronic format, or only in summary form. Also, the information generated may be too voluminous to allow effective manual review. For example, one posting to the general ledger may result from the automated summarization of information from hundreds of locations and thousands of documents.
8. **Nature of information systems hardware and software.** The nature of information systems hardware and software can affect inherent risk, as illustrated below.
   * The type of information system processing (online, batch oriented, or distributed) presents different levels of inherent risk. For example, the inherent risk of unauthorized transactions and data entry errors may be greater for online processing than for batch-oriented processing.
   * Peripheral access devices or system interfaces can increase inherent risk. For example, internet and dial-up access to a system increase the system’s accessibility to additional persons and therefore increase the risk of unauthorized access to computer resources.
   * Distributed networks enable multiple computer-processing units to communicate with each other, increasing the risk of unauthorized access to computer resources and possible data alteration. On the other hand, distributed networks may decrease the risk of conflicting computerized data between multiple processing units.
   * Software programs developed in-house may have higher inherent risk than vendor-supplied software that has been thoroughly tested and is in general commercial use.
   * Because of the nature of information systems hardware and software, management should design control activities to limit user access to information technology through authorization control activities, such as providing a unique user identification or token to authorized users. Management should also design other control activities to promptly update access rights when employees change job functions or leave the entity (Green Book 11.14).
9. **Unusual transactions.** As with manual systems, unusual information system processing transactions increase inherent risk. Programs developed to process such transactions may not be subject to the same procedures as programs developed to process routine transactions.

Legal and Regulatory Framework

1. The laws, regulations, contracts, and grant agreements applicable to the entity constitute its legal and regulatory framework. The auditor should obtain a general understanding of the framework, such as

* the laws, regulations, contracts, and grant agreements that directly determine the amounts and disclosures in the financial statements and
* other laws, regulations, contracts, and grant agreements that might have a fundamental effect on the entity’s operations.

The auditor should also obtain a general understanding of how the entity is complying with the framework, such as

* ensuring and documenting compliance;
* preventing noncompliance; and
* identifying, evaluating, and accounting for litigation, contract, and grant agreement claims, or a combination of these. (AU-C 250.12 and .A8)

Accounting Estimates

1. For accounting estimates, the auditor should obtain an understanding of the following (AU-C 540.12a–.12d and .12f):
   1. the entity’s transactions and other events or conditions that may give rise to the need for or changes in accounting estimates to be recognized or disclosed in the financial statements;
   2. the requirements of the applicable financial reporting framework related to accounting estimates (generally U.S. GAAP) (including the recognition criteria, measurement bases, and the related presentation and disclosure requirements) and how they apply in the context of the nature and circumstances of the entity and its environment;
   3. regulatory factors relevant to the entity’s accounting estimates, including, when applicable, regulatory frameworks;
   4. the nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity’s financial statements, based on the auditor’s understanding in items a through c; and
   5. how management identifies the need for and applies specialized skills or knowledge related to accounting estimates, including with respect to the use of management's specialists.

See AU-C 540.A19 through .A28 for additional guidance on the procedures discussed above. Additional requirements for accounting estimates are discussed in FAM 260 relating to internal control, FAM 265 relating to risk assessment, FAM 340 relating to control activities, and FAM 905 relating to substantive testing.

Relationships and Transactions with Disclosure Entities, Related Parties, and Public-Private Partnerships

1. For relationships and transactions with disclosure entities, related parties, and public-private partnerships, the auditor should inquire of management and others within the entity regarding

* the identity of the entity’s disclosure entities, related parties, and public-private partnerships, including changes from the prior period;
* the nature of the relationships (including ownership structure) between the entity and these disclosure entities, related parties, and public-private partnerships;
* the business purpose of entering into a transaction with the disclosure entity, related party, or public-private partnership, versus with an unrelated party; and
* whether the entity entered into, modified, or terminated any transactions with these disclosure entities, related parties, and public-private partnerships during the period and, if so, the type and business purposes of the transactions (AU-C 550.14).

Additional requirements related to disclosure entities, related parties, and public-private partnerships are discussed in FAM 265 relating to risk assessment procedures, FAM 280 relating to sharing of information and maintaining alertness, FAM 340 relating to understanding control activities, FAM 904 relating to substantive testing, and FAM 550 relating to conclusions.

1. For relationships with **disclosure entities**, the auditor should also inquire of management to obtain an understanding of the

* nature and magnitude of relevant activity with these disclosure entities during the period and
* nature of the entity’s financial and nonfinancial risks, potential benefits, and exposure to gains and losses from past or future operations of these disclosure entities.

1. For relationships with **public-private partnerships**, the auditor should also inquire of management to obtain an understanding of the

* purpose, objective, and rationale for the public-private partnership and the relative benefits/revenues being received in exchange for the entity’s monetary or nonmonetary consideration;
* entity’s statutory authority for entering into the public-private partnership;
* source and amounts of the funding of the public-private partnership over its expected life;
* operational and financial structure of the public-private partnership, including the entity’s rights and responsibilities; and
* contractual risks of loss the entity is undertaking within the public-private partnership.

Sources of the Auditor’s Understanding

1. The auditor may gather planning information through different methods (observation, inspection, interviews, reading policy and procedure manuals, etc.) and from a variety of sources, including

* top-level entity management;
* entity management responsible for significant programs;
* the IG office and internal audit management (including any internal control officer);
* others in the audit organization concerning other completed, planned, or in-progress assignments;
* personnel in the Special Investigator Unit; and
* entity legal representatives.

1. The auditor may gather information from relevant reports and articles issued by or about the entity, including

* the entity’s prior PARs, AFRs, or annual reports;
* other financial information;
* Federal Managers’ Financial Integrity Act of 1982 (FMFIA) reports and supporting documentation;[[20]](#footnote-21)
* management or auditor reports about financial management systems’ substantial compliance with the three FFMIA requirements (for CFO Act agencies only);
* the entity’s budget and related reports on budget execution;
* GAO reports (including those for performance audits);
* IG and internal audit reports (including those for performance audits and other work);
* service organization reports (see FAM 640);
* congressional hearings and reports;
* consultants’ reports; and
* material published about the entity in newspapers, magazines, internet sites, and other publications.

1. Audit documentation from prior-year audits may contain useful information for planning the current-year audit. Based on AU-C 315.16, the auditor should evaluate whether such information remains relevant and reliable for planning the current audit. The auditor should update any prior-year information that is to be used as part of the current-year audit documentation so that it reflects the current-year operations, environment, risks, and so forth.

If a different auditor performed the prior-year audit, the current-year auditor should address the need for access to that audit documentation as part of the current-year audit contract. As discussed in AU-C 510.A7, the extent, if any, to which a predecessor auditor permits access to its audit documentation is a matter of professional judgment.

225 – Perform Preliminary Analytical Procedures

1. As part of the risk assessment procedures, the auditor should perform preliminary analytical procedures to

* understand the entity’s operations, including current-year transactions and events;
* identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends that may indicate risks of material misstatement, including any risks related to fraud (see FAM 265); and
* determine the nature, extent, and timing of further audit procedures to be performed.

1. There may be situations in which the auditor may not be able to perform preliminary analytical procedures; this often relates to the reliability of comparative information. For example, in a first-year audit, comparative information might be unreliable. Therefore, preliminary analytical procedures may be limited. Additionally, for some accounts, it may be difficult to perform preliminary analytical procedures on an interim basis because of the lack of reliable information until year-end.
2. The auditor generally should perform the following steps to achieve the objectives of preliminary analytical procedures:
3. **Develop expectations.** The auditor develops expectations for account balances based on plausible relationships that are reasonably expected to exist. For example, as loan activity increases, the auditor would also expect loans receivable balances to increase. If the loans receivable balances decreased, the auditor should make inquiries to understand why. A decrease could be caused by higher loan payoffs, write-offs, or some other logical reason. However, the decrease could also have occurred because of an error or fraud.

The financial data used in preliminary analytical procedures generally are summarized at a high level, such as the level of financial statements. If financial statements are not available, the auditor may use trial balances, the budget, or financial summaries to determine expectations for the entity’s financial position and results of operations. When preliminary analytical procedures use data summarized at a high level, the results of these procedures provide only a broad initial indication about whether a material misstatement may exist. The auditor should consider the results of these procedures along with other information gathered when identifying risks of material misstatement.

1. **Compare current-year amounts to expectations.** Use of unaudited comparative data may not allow the auditor to identify significant fluctuations, particularly if an item consistently has been treated incorrectly, for example, if all accruals were not recorded. Also, the auditor may identify fluctuations that are not really fluctuations because of errors or omissions in unaudited comparative data.

Key to effective preliminary analytical procedures is using information that is comparable in terms of the time period presented and the presentation (i.e., same level of detail and consistent grouping of detailed accounts into summarized amounts used for comparison).

The auditor may perform ratio analysis on current-year data and compare the current year’s ratios with expectations based on those derived from prior periods or budgets. The auditor does this to study the relationships among components of the financial statements and to increase auditor knowledge of the entity’s activities. The auditor uses ratios that are relevant indicators or measures for the entity. Also, the auditor should consider any trends in the entity-prepared performance indicators.

1. **Identify significant fluctuations.** The auditor identifies fluctuations, which are differences between the recorded amounts and the amounts expected by the auditor, based on comparative financial information and the auditor’s knowledge of the entity. Fluctuations refer to both unexpected differences between current-year amounts and comparative financial information as well as the absence of expected differences.

The auditor generally should establish parameters for identifying significant fluctuations. When setting these parameters, the auditor may consider the amount of a fluctuation in terms of absolute size, the percentage difference, or both. The amount and percentage used are usually based on materiality. An example of a parameter is “All fluctuations in excess of $10 million and/or 15 percent of the expectation or other unusual fluctuations (such as debit amounts in accounts having normally credit balances) will be considered significant.”

1. **Inquire about significant fluctuations.** Fluctuations may result from errors or fraud, from changes in operations, or from changes in the entity organization that the auditor did not consider when determining expectations. The auditor should discuss identified fluctuations with appropriate entity personnel. This discussion should focus on whether the fluctuation could result from error or fraud and whether the auditor adequately understands the entity’s operations. In doing this, the auditor should consider the types of errors or fraud that could have caused the fluctuations.

For preliminary analytical procedures, the auditor does not need to corroborate the explanations as they will be tested later. However, the auditor should determine whether the explanations obtained appear reasonable and consistent. If the entity personnel indicate that the operations or organization has changed, the auditor may adjust the expectations and then determine whether there is still a significant fluctuation. The inability of appropriate entity personnel to explain the cause of a fluctuation may indicate a risk of material misstatement due to error or fraud.

1. The auditor should consider the results of preliminary analytical procedures in assessing the risks of material misstatement due to error or fraud (see FAM 265).

230 – Determine Materiality

1. Materiality is one of several factors the auditor uses to determine the nature, extent, and timing of procedures. Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.[[21]](#footnote-22) Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both. Judgments about materiality involve both quantitative and qualitative considerations, such as the public accountability of the entity under audit, various legal and regulatory requirements, and the visibility and sensitivity of government programs. Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered. (AU-C 320.02).
2. When establishing the overall audit strategy, the auditor should determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, one or more particular line items, accounts, note disclosures, or classes of transactions exist for which there is a substantial likelihood that misstatements of lesser amounts than materiality for the financial statements as a whole would influence the judgment made by a reasonable user based on the financial statements, the auditor also should determine the materiality level or levels to be applied to the particular line items, accounts, note disclosures, or classes of transactions. (AU-C 320.10)
3. Materiality is based on the concept that items of little importance, which would not affect the judgment or conduct of a reasonable user, do not require auditor investigation. Materiality has both quantitative and qualitative aspects. Certain misstatements or omissions, even though quantitatively immaterial, could have a material impact on or warrant disclosure in the financial statements for qualitative reasons.
4. For example, intentional misstatements or omissions (fraud) usually are more critical to the financial statement users than are unintentional errors of equal amounts. This is because users generally consider an intentional misstatement more serious than clerical errors of the same amount.
5. U.S. GAAS, as incorporated in GAGAS, indicates that the auditor should use materiality in planning and performing the audit; evaluating the effect of identified misstatements on the audit, and the effect of uncorrected misstatements, if any, on the financial statements; and forming the opinion in the auditor’s report (AU‑C 320.05).
6. The term materiality is used within several contexts in the FAM. The FAM uses the following terms that relate to materiality:

* **Materiality for the financial statements as a whole** is based on professional judgment and is a preliminary estimate in relation to the financial statements as a whole, primarily based on quantitative measures. It is used to determine performance materiality, which in turn is used to determine tolerable misstatement. These are then used to determine the risks of material misstatement and the nature, extent, and timing of substantive audit procedures. It is also used to identify significant provisions of applicable laws, regulations, contracts, and grant agreements for compliance testing.
* **Performance materiality** is the amount or amounts set by the auditor as a portion of materiality that the auditor allocates to line items, accounts, note disclosures, and classes of transactions (such as disbursements). The auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures (AU-C 320.11). Performance materiality is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole (AU‑C 320.09).
* **Tolerable misstatement** is the application of performance materiality to a particular substantive sampling procedure. Tolerable misstatement is defined in AU-C 530.05 as a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. Based on the auditor’s judgment, the auditor may set tolerable misstatement equal to or less than performance materiality, as discussed in FAM 230.13, and may set different amounts of tolerable misstatement for substantive sampling procedures of specific line items, accounts, note disclosures, classes of transactions, or assertions.
* **Clearly trivial** is the amount below which misstatements would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. Misstatements that are clearly trivial are those that are clearly inconsequential, whether taken individually or in the aggregate and whether judged by any criteria of size, nature, or circumstances (AU-C 450.A2 and .A3). The clearly trivial amount set by the auditor should be substantially below performance materiality so that the aggregate of many items at the clearly trivial amount would not exceed tolerable misstatement. For example, a threshold that is 5 percent (or less) of performance materiality may be sufficiently low.

1. The FAM also uses the term materiality in the reporting phase.

* **FMFIA materiality** is the threshold that management establishes for determining whether a matter meets OMB criteria for reporting matters under FMFIA, as described in FAM 580.60 and .61.
* **Management representation letter materiality.** See FAM 1001.07.
* **Legal counsel materiality.** See FAM 1002.19 through .22.

1. The following guidelines provide the auditor with a framework for determining materiality. However, this framework is not a substitute for professional judgment. The auditor may determine materiality outside of these guidelines. In such circumstances, the basis for the determination must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved. The auditor should document materiality and the method of determining materiality. The audit director should review and approve the documentation.

The auditor should determine materiality in relation to the element of the financial statements that the auditor judges is most significant to the primary users of the statements (the materiality benchmark). The auditor generally uses preliminary information to estimate the materiality benchmark. This may be prior years’ audited financial statements or current-year unaudited and unadjusted interim information. The auditor should revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular line items, accounts, note disclosures, or classes of transactions) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially (AU-C 320.12).

To provide reasonable assurance that sufficient audit procedures are performed, the auditor may estimate the materiality benchmark at the low end of the possible materiality benchmark. If the auditor concludes that a lower materiality than that initially determined for the financial statements as a whole (and, if applicable, materiality level or levels for particular line items, accounts, note disclosures, or classes of transactions) is appropriate, the auditor should determine whether it is necessary to revise performance materiality and whether the nature, timing, and extent of the further audit procedures remain appropriate (AU-C 320.13).

1. For capital-intensive entities, total assets may be an appropriate materiality benchmark. For expenditure-intensive entities, total expenses may be an appropriate materiality benchmark. Based on these concepts, the auditor generally should use as the materiality benchmark the greater of total assets or expenses. The materiality benchmark generally should be net of adjustments for intragovernmental balances and offsetting balances (see discussion of these adjustments in the next paragraph). The auditor may use other materiality benchmarks, such as total liabilities; equity; revenues; appropriations; or, if significant, line items.

If the statements are significantly different in magnitude, it may be appropriate to use different benchmarks to avoid over- or underauditing. For example, if an entity has a statement of social insurance with significantly large amounts compared to the statement of net cost, and the auditor uses total expenses from the statement of net cost as a benchmark, this could result in overauditing the statement of social insurance. Therefore, the auditor may determine a separate benchmark for the statement of social insurance.

The key is to use a materiality benchmark or benchmarks that the auditor believes are most critical to the users of the financial statements. This requires that the auditor understand users and the entity and the environment in which it operates.

1. In determining the materiality benchmark, the auditor should decide how to handle significant **intragovernmental** balances (such as funds with the Treasury, Treasury securities, and inter-entity balances) and offsetting balances (such as future funding sources that offset certain liabilities and collections that are offset by transfers to other government entities) because of their different risks. Further, combining all of the accounts may distort the auditor’s judgment when designing the nature, extent, and timing of audit procedures. Because these amounts were removed from the materiality benchmark, as discussed in the previous paragraph, the auditor generally should establish a separate materiality benchmark for significant intragovernmental or offsetting balances.

For example, an entity that collects and remits funds on behalf of other entities could have operating accounts that are small in comparison to the funds processed on behalf of other entities. In this example, the auditor would determine a separate materiality for auditing (1) the offsetting accounts, using the balance of the offsetting accounts as the materiality benchmark, and (2) the rest of the financial statements, using the materiality benchmark guidance in FAM 230.09.

1. The auditor generally should set materiality at 3 percent of the materiality benchmark. Although the auditor may use a mechanical means to calculate materiality, the auditor should use judgment in evaluating whether the calculated level is appropriate. The auditor also should consider adjusting the materiality benchmark for the impact of items such as unrecorded liabilities, contingencies, and other items that are not incorporated in the entity’s financial statements and therefore are not reflected in the materiality benchmark but may be important to the financial statement user.
2. The auditor generally should set performance materiality at one-third of materiality to allow for the precision of audit procedures. This guideline recognizes that misstatements may occur throughout the entity’s various accounts. The performance materiality represents the materiality used as a starting point to design audit procedures for assertions in line items, accounts, note disclosures, and classes of transactions. Doing so allows the auditor to detect an aggregate material misstatement in the financial statements. See FAM 545 for consideration of this precision allowance when evaluating the effects of misstatements on the financial statements for the purpose of reporting on the financial statements. The auditor may set a separate performance materiality level for a particular line item, account, note disclosure, or class of transactions.
3. The auditor generally sets tolerable misstatement for a specific test the same as for the performance materiality. However, the auditor may set a tolerable misstatement lower than the performance materiality for substantive sampling procedures of specific line items, accounts, note disclosures, classes of transactions, or assertions (which increases the extent of testing), particularly when

* the population from which the audit sample is selected approximates or is lower than the balance or activity being tested or
* the area tested is sensitive to the financial statement users or may be qualitatively material.

1. The materiality levels that the auditor sets should be used only by the auditor for planning and performing the audit and should not be used by management. Management should establish its own materiality for reporting purposes.

235 – Identify Material Line Items, Accounts, Note Disclosures, and Classes of Transactions; Applicable Assertions; and Significant Financial Management Systems

Identify Line Items, Accounts, Note Disclosures, and Classes of Transactions

1. The auditor should identify

* line items in the financial statements,
* accounts in the entity’s general ledger that make up each line item,
* note disclosures in the notes to the financial statements, and
* classes of transactions that the entity processes.

These line items, accounts, note disclosures, and classes of transactions include budget-related information, such as that presented in the statement of budgetary resources, reconciliation of net cost to net outlays,[[22]](#footnote-23) and disclosure of the components of net position.

1. A **class of transactions** is a category of events or activities that result in the recording of, or that support, financial data in the entity’s general ledger accounts and, ultimately, the reporting of financial statement line items or disclosure of information in the notes to the financial statements. Classes of transactions are classified as transaction-related or line item/account-related.

* Transaction-related classes of transactions are the events and activities that occur during the period under audit and result in debit and credit entries to the entity’s accounts (e.g., billing, purchasing, cash receipts, cash disbursements, journal vouchers, and adjusting entries). Transactions within each class are generally subject to similar risks and internal controls. These classes of transactions generally affect line items reported on all financial statements.
* Line item/account-related classes of transactions are the activities (e.g., maintenance of subsidiary records) that support balances that exist at period-end (e.g., cash balance, property balance, and accounts payable balance). These classes of transactions generally affect line items reported on the balance sheet or ending balances reported on the statement of budgetary resources.

1. The auditor may group related line items, accounts, note disclosures, and classes of transactions to form **cycles**. For example, the auditor might group the billing class of transactions, cash receipts class of transactions, accounts receivable line item and related accounts, revenue line item and related accounts, and related note disclosures to form the revenue cycle. Grouping related items into cycles can aid the auditor in preparing audit documentation and designing audit procedures that are effective, efficient, and relevant to financial reporting objectives. The auditor uses professional judgment in deciding what items to include in a cycle, considering the relationships between them and the efficiencies that can be achieved by grouping them for purposes of preparing audit documentation and performing audit procedures. As appropriate, the auditor may designate subcycles within larger cycles.

Identify Material Line Items, Accounts, and Classes of Transactions

1. The auditor should determine which of the entity’s line items, accounts, and classes of transactions identified in FAM 235.01 are material. Identifying material line items, accounts, and classes of transactions lays the foundation for identifying risks of material misstatement discussed in FAM 265 and preparing the line item risk analysis (LIRA) form at FAM 395 H. A **line item, account, or class of transactions** is material if it has one or more of the following characteristics:

* Its balance or activity equals or exceeds performance materiality.
* Its balance or activity could be understated by an amount that equals or exceeds performance materiality. For example, a small or zero balance for an accrued liability could be understated by a material amount.
* Its balance or activity is qualitatively material, considering such factors as public accountability of the entity, legal or regulatory requirements, and visibility or sensitivity of government programs.

The auditor may also identify a line item, account, or class of transactions as material if it does not meet the characteristics above, but its balance or activity, when combined with other immaterial items, equals or exceeds performance materiality in the aggregate.

Identify Material Note Disclosures

1. Note disclosures related to material line items, accounts, and classes of transactions are material note disclosures. In addition, the auditor should determine whether other note disclosures that are not directly related to a line item or account are material. Examples of note disclosures that are not directly related to a line item or account include those for fiduciary activities, subsequent events, and reconciliation of net cost to net outlays.
2. Note disclosures may be quantitative or qualitative. A **quantitative** note disclosure is material if it meets the criteria in FAM 235.04. Determining whether a **qualitative** note disclosure is material, in the context of the applicable financial reporting framework (generally U.S. GAAP) and the entity’s circumstances, is a matter that involves the exercise of professional judgment. Examples of qualitative note disclosures include

* information about objectives, policies, and processes for managing budgetary resources;
* information about events or circumstances that led to an impairment loss;
* description of an accounting policy; and
* description of the sensitivity of an exchange rate.

Identify Applicable Assertions

1. Most of the auditor’s work in forming an opinion on financial statements consists of obtaining and evaluating sufficient appropriate evidence concerning assertions. The auditor uses assertions to consider the different types of potential misstatements that may occur when identifying, assessing, and responding to the risks of material misstatement. Assertions are representations, explicit or otherwise, with respect to the recognition, measurement, presentation, and disclosure of information in the financial statements, which are inherent in management, representing that the financial statements are prepared in accordance with the applicable financial reporting framework (generally U.S. GAAP) (AU-C 315.12).
2. The FAM provides the following five assertions:
3. **Existence or occurrence:** Transactions and events have occurred during the given period, have been recorded in the proper accounts, and pertain to the entity. An entity’s assets, liabilities, net position, and budgetary balances exist at a given date and have been recorded in the proper accounts. Projected revenues and expenditures in the sustainability financial statements are valid.
4. **Completeness:** All transactions and events that should have been recorded have been recorded in the proper period and accounts. All assets, liabilities, net position, and budgetary balances that should have been recorded have been recorded in the proper period and accounts, and are properly included in the financial statements. Projections in the sustainability financial statements include all estimated future revenues and expenditures at present value that should have been included.
5. **Rights and obligations:** The entity holds or controls the rights to assets, and liabilities are the obligations of the entity, at a given date. The entity holds or controls the rights to budgetary resources, and budgetary obligations pertain to the entity, at a given date.
6. **Accuracy, valuation, and allocation:** Amounts and other data relating to recorded transactions and events have been appropriately recorded.[[23]](#footnote-24) Assets, liabilities, net position, budgetary balances, and projections in the sustainability financial statements have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded.
7. **Presentation and disclosure:** Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. Note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP. All note disclosures that should have been included in the financial statements have been included. Disclosed transactions and events have occurred and pertain to the entity.

AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, provides 12 assertions within two categories. See FAM 235 A for a comparison of the above five assertions to the 12 assertions in AU-C 315.

1. For each material line item, account, note disclosure, and class of transactions, the auditor should identify the **applicable assertions**. Some assertions may not be applicable for a given line item, account, note disclosure, or class of transactions. For example, the rights and obligations assertion is not applicable to revenues and expenses.

Identify Significant Financial Management Systems

1. For material line items, accounts, note disclosures, and classes of transactions, the auditor should identify the financial management systems that support them. Financial management systems are the financial systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to operating and maintaining system functions. Financial management systems are used extensively in the federal government. Many of these systems share programs, data files, and hardware with one another and are connected to the larger corporate network that they depend on for services such as authentication and monitoring. In addition to producing financial and accounting information, these systems typically generate other information and reports used in management decision-making.
2. If afinancial management system supports a material line item, account, note disclosure, or class of transactions, then it generally is significant for evaluating the effectiveness of the entity’s internal control over financial reporting. There may be multiple financial management systems that support a particular line item, account, note disclosure, or class of transactions. The auditor should determine whether all significant financial management systems have been identified. If the auditor determines that a financial management system that a service organization maintains is significant for evaluating the effectiveness of the entity’s internal control over financial reporting, the auditor should follow the guidance in FAM 640.
3. For CFO Act agencies, which are subject to FFMIA, the auditor determines whether the financial management systems comply substantially with (1) federal financial management systems requirements, (2) federal accounting standards, and (3) the *U.S. Standard General Ledger* (USSGL) at the transaction level (see FAM 701 and 701 A). If the auditor determines that a financial management system is significant for evaluating the effectiveness of the entity’s internal control over financial reporting, then it generally is significant for determining whether the system complies substantially with FFMIA.

In addition to the financial management systems involved in processing financial transactions and preparing financial statements, significant financial management systems covered by FFMIA may also include systems supporting financial planning, management reporting, and budgeting activities; systems accumulating and reporting cost information; and the financial portions of mixed systems, such as benefit payment, logistics, personnel, and acquisition systems.

Document Material Line Items, Accounts, Note Disclosures, and Classes of Transactions; Applicable Assertions; and Significant Financial Management Systems

1. The auditor should prepare a **cycle matrix** or equivalent that links material line items, accounts, note disclosures, and classes of transactions to the related significant financial management systems, LIRA forms, and cycles, as applicable.
2. The auditor should also document material line items, accounts, note disclosures, and classes of transactions, along with the applicable assertions, on the **LIRA form** at FAM 395 H or equivalent.

235 A – Comparison of AU-C 315 Assertions to FAM 235 Assertions

1. AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,* identifies 12 assertions within two categories: (1) classes of transactions and events, and note disclosures, for the period under audit and (2) account balances, and note disclosures, at the period-end. The auditor may use these categories of assertions or may express them differently, provided all aspects of the assertions have been covered (AU-C 315.A218). Table 235 A.1 compares the 12 assertions in AU-C 315 to the five assertions described in FAM 235.

**Table 235 A.1: Comparison of AU-C 315 Assertions to FAM 235 Assertions[[24]](#footnote-25)**

| **AU-C 315 assertions** | **FAM 235 assertions** |
| --- | --- |
| **I. Assertions about classes of transactions and events, and note disclosures, for the period under audit** | |
| 1. Occurrence – Transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity. | 1. **Existence or occurrence** – **Transactions and events have occurred** during the given period, have been recorded in the proper accounts, **and pertain to the entity.** An entity’s assets, liabilities, net position, and budgetary balances exist at a given date and have been recorded in the proper accounts. Projected revenues and expenditures in the sustainability financial statements are valid.  5. Presentation and disclosure – Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. Note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP. All note disclosures that should have been included in the financial statements have been included.Disclosed transactions and events have occurred and pertain to the entity. |
| 2. Completeness – All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included. | 2. Completeness – All transactions and events that should have been recorded have been recorded in the proper period and accounts.All assets, liabilities, net position, and budgetary balances that should have been recorded have been recorded in the proper period and accounts and properly included in the financial statements. Projections in sustainability financial statements include all estimated future revenues and expenditures at present value.  5. Presentation and disclosure – Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. Note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP. **All note disclosures that should have been included in the financial statements have been included.** Disclosed transactions and events have occurred and pertain to the entity. |
| 3. Accuracy – Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described. | 4. **Accuracy, valuation, and allocation** – **Amounts and other data relating to recorded transactions and events have been recorded appropriately.** Assets, liabilities, net position, budgetary balances, and projections in sustainability financial statements have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded.  5. Presentation and disclosure – Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. **Note disclosures are appropriately measured and described** and are relevant and understandable in the context of the requirements of U.S. GAAP. All note disclosures that should have been included in the financial statements have been included.Disclosed transactions and events have occurred and pertain to the entity. |
| 4. Cutoff – Transactions and events have been recorded in the correct accounting period. | 1.  **Existence or occurrence** – **Transactions and events have occurred during the given period**, have been recorded in the proper accounts, and pertain to the entity. An entity’s assets, liabilities, net position, and budgetary balances exist at a given date and have been recorded in the proper accounts. Projected revenues and expenditures in sustainability financial statements include all estimated future revenues and expenditures at present value.  2. Completeness **–** All transactions and events that should have been recorded have been recorded in the proper period and accounts. All assets, liabilities, net position, and budgetary balances that should have been recorded have been recorded in the proper period and accounts and are properly included in the financial statements. Projections in sustainability financial statements include all estimated future revenues and expenditures at present value. |
| 5. Classification – Transactions and events have been recorded in the proper accounts. | 1. Existence or occurrence – Transactions and events have occurred during the given period**, have been recorded in the** proper accounts, and pertain to the entity. An entity’s assets, liabilities, net position, and budgetary balances exist at a given date and have been recorded in the proper accounts. Projected revenues and expenditures in sustainability financial statements include all estimated future revenues and expenditures at present value.  2. Completeness – All transactions and events that should have been recorded have been recorded in the proper period and accounts.All assets, liabilities, net position, and budgetary balances that should have been recorded have been recorded in the proper period and accounts and are properly included in the financial statements. Projections in sustainability financial statements include all estimated future revenues and expenditures at present value. |
| 1. **Presentation** – Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework (generally U.S. GAAP). | 5. Presentation and disclosure – **Financial and other information in the financial statements is appropriately aggregated or disaggregated, and clearly described. Note disclosures** areappropriately measured and described and **are relevant and understandable in the context of the requirements of U.S. GAAP**. All note disclosures that should have been included in the financial statements have been included.Disclosed transactions and events have occurred and pertain to the entity. |

| **AU-C 315 assertions** | | **FAM 235 assertions** |
| --- | --- | --- |
| **II. Assertions about account balances, and note disclosures, at the period-end** | | |
| 7. Existence – Assets, liabilities, and equity interests exist. | 1. **Existence or occurrence** – Transactions and events have occurred during the given period, have been recorded in the proper accounts, and pertain to the entity. **An entity’s assets, liabilities, net position,** and budgetary balances **exist at a given date** andhave been recorded in the proper accounts. Projected revenues and expenditures in sustainability financial statements include all estimated future revenues and expenditures at present value. | |
| 8. Rights and obligations – The entity holds or controls the rights to assets, and liabilities are the obligations of the entity. | 3. Rights and obligations – The entity holds or controls the rights to assets, and liabilities are the obligations of the entity, at a given date. The entity holds or controls the rights to budgetary resources, and budgetary obligations pertain to the entity, at a given date. | |
| 9. Completeness – All assets, liabilities, and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included. | 2. **Completeness** – All transactions and events that should have been recorded have been recorded in the proper period and accounts. **All assets, liabilities, net position,** and budgetary balances **that should have been recorded have been recorded** in the proper period and accounts and are properly included in the financial statements. Projections in sustainability financial statements include all estimated future revenues and expenditures at present value.  5. Presentation and disclosure – Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. Note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP. **All note disclosures that should have been included in the financial statements have been included.** Disclosed transactions and events have occurred and pertain to the entity. | |
| 10. **Accuracy**, valuation, and allocation – Assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described. | 4. Accuracy, valuation, and allocation – Amounts and other data relating to recorded transactions and events have been recorded appropriately. Assets, liabilities, net position, budgetary balances, and projections in sustainability financial statements have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded.  5. Presentation and disclosure – Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. **Note disclosures are appropriately measured and described** and are relevant and understandable in the context of the requirements of U.S. GAAP. All note disclosures that should have been included in the financial statements have been included.Disclosed transactions and events have occurred and pertain to the entity. | |
| 11. **Classification** – Assets, liabilities, and equity interests have been recorded in the proper accounts. | 1. **Existence or occurrence** – Transactions and events have occurred during the given period, have been recorded in the proper accounts, and pertain to the entity. **An entity’s assets, liabilities, net position**, and budgetary balancesexist at a given date and **have been recorded in the proper accounts**. Projected revenues and expenditures in sustainability financial statements include all estimated future revenues and expenditures at present value.  2. Completeness **–** All transactions and events that should have been recorded have been recorded in the proper period and accounts. **All assets, liabilities, net position,** and budgetary balances that should have been recorded **have been recorded in the proper** period and **accounts** and are properly included in the financial statements. Projections in sustainability financial statements include all estimated future revenues and expenditures at present value. | |
| 12. **Presentation** – Assets, liabilities, and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework (generally U.S. GAAP). | 5. Presentation and disclosure – **Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. Note disclosures are** appropriately measured and described and are **relevant and understandable in the context of the requirements of U.S. GAAP**. All note disclosures that should have been included in the financial statements have been included.Disclosed transactions and events have occurred and pertain to the entity. | |

245 – Identify Significant Provisions of Applicable Laws, Regulations, Contracts, and Grant Agreements

1. AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, provides audit requirements related to laws and regulations, both those that have a direct effect and those that have an indirect effect on the financial statements. GAGAS (2018) 6.15 extends these requirements to the auditor’s consideration of compliance with provisions of contracts and grant agreements.
2. A direct effect means that the provision specifies

* the nature and/or dollar amount of transactions that may be incurred (such as obligation, outlay, or borrowing restrictions);
* the method used to record such transactions (such as revenue recognition policies); or
* the nature and extent of information to be reported or disclosed in the financial statements (such as the statement of budgetary resources).

For example, an entity enabling statute may contain provisions that limit the nature and amount of obligations or outlays and therefore have a direct effect on determining amounts and disclosures in the financial statements. If a provision’s effect on the financial statements is limited to contingent liabilities as a result of noncompliance (typically for fines, penalties, and interest), such a provision does not have a direct effect on determining financial statement amounts and note disclosures. The concept of direct effect is also discussed in AU-C 250.

1. The auditor should obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by those provisions of laws, regulations, contracts, and grant agreements generally recognized to have a direct effect on their determination (AU-C 250.13).
2. The auditor generally should use the General Compliance Checklist in FAM 802 or equivalent to determine which laws and regulations are significant for testing compliance.
3. In contrast, an indirect effect relates generally to the entity’s operating aspects and not to directly affecting the determination of amounts or disclosures in the financial statements. In other words, the effect may be limited to recording or disclosing liabilities **arising from noncompliance**. Examples of provisions of indirect laws and regulations include those related to environmental cleanup and occupational safety and health.
4. The auditor should identify the significant provisions of applicable laws, regulations, contracts, and grant agreements. These provisions are those (1) for which compliance can be objectively determined and (2) that have a direct effect on the determination of material amounts and disclosures in the financial statements as defined in FAM 245.07b. To aid the auditor in this process, the FAM classifies provisions of laws and regulations into the following categories:

* **Transaction-based provisions** are those for which compliance is determined for individual transactions. For example, provisions of the Prompt Payment Act require that late payments be individually identified and interest paid on such late payments.
* **Quantitative-based provisions** are those that require the accumulation or summarization of amounts for measurement. These provisions may contain minimum, maximum, or targeted amounts (restrictions) for the accumulated/summarized information. For example, provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 prohibit the U.S. Environmental Protection Agency from exceeding certain spending limits on specific projects.
* **Procedural-based provisions** are those that require the entity to implement policies or procedures to achieve certain objectives. For example, provisions of the Single Audit Act require the awarding entity to review certain financial information about recipients.

During the planning phase, the auditor should attempt to identify the significant provisions of contracts and grant agreements, recognizing that during this phase the auditor may not be in position to identify all the significant provisions of contracts and grant agreements. However, as the audit progresses, the auditor may become aware of significant provisions of contracts and grant agreements and, as a result, perform transaction testing of these contracts and grant agreements provisions. For example, the auditor may test the budgetary and proprietary transactions associated with lease agreement provisions.

1. For each significant provision, the auditor should identify and evaluate related compliance controls and should test compliance with the provision. To identify such significant provisions, the auditor should do the following:
2. Review the list of laws included in FAM 295 H. The auditor should also review the list of laws, regulations, contracts, and grant agreements that the entity has determined might be significant. In addition, the auditor should identify any laws, regulations, contracts, or grant agreements (in addition to those identified in FAM 295 H and by the entity) that have a direct effect on determining amounts and disclosures in the financial statements. These might include (1) new laws and regulations and (2) entity-specific laws and regulations. The auditor’s Office of the General Counsel (OGC) assists the auditor in identifying laws and regulations. The meaning of direct effect is discussed in FAM 245.02.
3. Identify those provisions that are significant. A provision is significant if (1) compliance with the provision can be measured objectively and (2) it meets one of the following criteria for determining that the provision has a direct effect on determining material amounts and disclosures in the financial statements:
   * **Transaction-based provisions:** The aggregate amount of transactions the entity processes that are subject to the provision equals or exceeds materiality.
   * **Quantitative-based provisions:** The amount required to be accumulated or summarized for measurement by the provision equals or exceeds materiality.
   * **Procedural-based provisions:** The provision broadly affects all or a segment of the entity’s operations that process transactions equal to or exceeding materiality in the aggregate. For example, a provision may require that the entity establish procedures to monitor the receipt of certain information from grantees. In determining whether to test compliance with this provision, the auditor should determine whether the total amount of money granted equals or exceeds materiality.
4. Significant provisions of contracts and grant agreements may not be able to be identified during planning. If so, the auditor should determine during planning the approach for identifying and testing such provisions during later phases of the audit. The provisions may be identified as part of substantive testing of transactions and balances, when the auditor finds that material amounts and note disclosures related to such transactions and balances are determined by contracts or grant agreements. For example, a contract or grant agreement generally contains certain information, such as the amount or basis for determining the amounts to be paid and the timing of such payments, that directly affects the amounts reported or disclosed in the financial statements. To test such transactions and balances, the auditor may determine that it is necessary to examine contracts or grant agreements to obtain sufficient appropriate evidence supporting the transaction or balance. In other instances, such as those related to the provision of routine goods and services, the auditor may determine that it is not necessary to examine contracts or grant agreements to obtain sufficient appropriate evidence supporting the transaction or balance.
5. Based on AU-C 250.A10, the auditor’s responsibilities regarding misstatements resulting from noncompliance with laws, regulations, contracts, and grant agreements having a direct effect on the determination of material amounts and disclosures in the financial statements is the same as that for misstatements caused by fraud or error. Such risks of material misstatement resulting from noncompliance may be at the assertion or financial statement level.
6. For **indirect** laws, regulations, contracts, or grant agreements, the auditor should perform the following procedures that may identify instances of noncompliance that may have a material effect on the financial statements:
7. Inquire of management and, when appropriate, those charged with governance regarding policies and procedures that prevent noncompliance and whether the entity is in compliance with those provisions (AU-C 250.14a).
8. Consider instances of noncompliance that may be identified in performing other audit procedures and determine if they could have a material effect on the financial statements.
9. Review reports issued by other oversight bodies of the audited entity, such as the IG’s office, for any reported instances of noncompliance and determine if they could be material to the financial statements.
10. Inspect correspondence, if any, with relevant regulatory authorities (AU‑C 250.14b).

Unless possible instances of noncompliance with indirect laws, regulations, contracts, or grant agreements come to the auditor’s attention during the audit, no further procedures with respect to indirect laws, regulations, contracts, and grant agreements are necessary. The auditor is not responsible for testing compliance controls over or compliance with any indirect laws, regulations, contracts, or grant agreements (AU-C 250.16).

1. The auditor may test compliance with **indirect** laws, regulations, contracts, and grant agreements. For example, if the auditor becomes aware that the entity has operations similar to those of another entity that was recently in noncompliance with environmental laws and regulations, the auditor may test for compliance with such laws and regulations. The auditor may also test provisions of direct laws, regulations, contracts, and grant agreements that do not meet the materiality criteria in FAM 245.07b but that are deemed significant because they are qualitatively material, such as laws and regulations that have generated significant interest by the Congress, the media, or the public.
2. In considering regulations to test for compliance, the auditor should consider externally imposed requirements issued pursuant to the Administrative Procedure Act. These would include regulations in the *U.S.* *Code of Federal Regulations* as well as OMB circulars and bulletins to the extent issued under direction of law. It would not include OMB circulars and bulletins to the extent issued as a matter of policy or guidance under the entity’s general authority. Internal policies, manuals, and directives may be the basis for internal controls but are not regulations to consider for testing compliance. The auditor should consult its OGC if the direction of law determination is not clear.
3. The auditor should remain alert to the possibility that procedures applied during other aspects of the audit might indicate actual or suspected noncompliance with provisions of laws, regulations, contracts, or grant agreements (AU-C 250.15). See FAM 460.06 for the procedures to perform for instances of noncompliance or suspected noncompliance (whether direct or indirect).

250 – Identify Relevant Budget Restrictions

1. The auditor should identify relevant budget restrictions, evaluate budget controls (see FAM 295 G), and design compliance-related audit procedures relevant to budget restrictions. Some key documents that may be obtained from the entity or the auditor’s OGC are

* the Antideficiency Act (ADA), as provided primarily in 31 U.S.C. chapters 13, 15. Provisions: 31 U.S.C. §§ 1341(a)(1)(A), (B); and 31 U.S.C. § 1517(a);
* the Purpose Statute, as provided in 31 U.S.C. § 1301;
* the Time Statute, as provided in 31 U.S.C § 1502;
* OMB Circular No. A-11, *Preparation, Submission and Execution of the Budget*, Part 4;
* the Impoundment Control Act, as provided in 2 U.S.C. chapter 17B; and
* the Federal Credit Reform Act (FCRA), as provided in 2 U.S.C. §§ 661-661f (if the entity has activity subject to this law). Provisions: 2 U.S.C. § 661c(b), (e).

Title 7 of GAO’s *Policy and Procedures Manual for Guidance of Federal Agencies* and GAO’s *Principles of Federal Appropriations Law* (commonly known as the Red Book) provide guidance on compliance with budget restrictions. The USSGL within the *Treasury Financial Manual* provides guidance on budgetary accounting.

1. Information relating to the entity’s appropriation (or other budget authority) for the period of audit includes

* authorizing statute;
* enabling statute;
* appropriation act and supplemental appropriation act;
* apportionments and budget execution reports (including OMB forms 132 and 133 and supporting documentation);
* Impoundment Control Act reports regarding rescissions and deferrals, if any;
* the OMB-approved system of funds control document; and
* any other information that the auditor deems to be relevant to understanding the entity’s budget authority, such as legislative history contained in committee reports or conference reports.

Although legislative histories are not legally binding, they may help the auditor understand the political environment surrounding the entity (e.g., why the entity has undertaken certain activities and the objectives of these activities). SFFAS 43, *Funds from Dedicated Collections: Amending SFFAS 27, Identifying and Reporting Earmarked Funds*, may also help the auditor identify revenues or other financing sources of the federal entity.

1. Through discussions with the auditor’s OGC and the entity, and by using the above information and information prepared by management, the auditor should identify all **legally binding** restrictions on the entity’s use of appropriated funds that are relevant to budget execution. This includes any restrictions on the amount, purpose, or timing of obligations and outlays (i.e., relevant budget restrictions). Additionally, the auditor should determine whether the entity has established any legally binding restrictions in its fund control regulations. An example of this would be the entity’s lowering the legally binding level for compliance with the Antideficiency Act to the allotment level.
2. The auditor should obtain advice from the auditor’s OGC on the implications if the entity were to violate these relevant budget restrictions. In the internal control phase, the auditor identifies the design of and tests the entity’s controls to prevent or detect noncompliance with these relevant restrictions. The auditor may evaluate controls over budget restrictions that are not legally binding but that may be considered sensitive or important.
3. During these discussions with the auditor’s OGC and the entity, the auditor should determine whether any of these relevant budget restrictions relate to significant provisions of applicable laws and regulations for purposes of testing compliance.
4. For an entity that does not receive appropriated funds, the auditor should identify budget-related requirements that are legally binding on the entity. These requirements, if any, are usually found in the statute that created the entity or its programs (such as the authorizing and enabling statute) as well as any subsequent amendments. Although budget information on these entities may be included in the President’s budget submitted to the Congress, this information usually is not legally binding. In general, certain budget-related restrictions (such as provisions of the Antideficiency Act) apply to government corporations but not to government-sponsored enterprises.

260 – Understand the Entity’s Internal Control

Overview of Internal Control

1. Internal control over financial reporting, as defined in OMB audit guidance, is a subset of the entity’s internal control and includes the following (GAGAS and OMB audit guidance expand compliance to include contracts and grant agreements).[[25]](#footnote-26)

* Reliability of **financial reporting**: Transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with U.S. GAAP, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition. (Note that certain **safeguarding** controls are part of financial reporting controls, although they are also operations controls. See FAM 310.07–.09.)
* **Compliance** with laws, regulations, contracts, and grant agreements: Transactions are executed in accordance with provisions of applicable laws, including those governing the use of budget authority; regulations; contracts; and grant agreements, noncompliance with which could have a material effect on the financial statements. (Note that **budget** controls are part of financial reporting controls as they relate to the statement of budgetary resources and the reconciliation of net cost to net outlays. They are also part of compliance controls in that they are used to manage and control the use of appropriated funds and other forms of budget authority in accordance with applicable law. These controls are described in more detail in FAM 295 G.)

1. Most controls relevant to the audit are likely to relate to financial reporting; however, not all controls that relate to financial reporting are relevant to the audit. In addition, some controls belong in more than one category of control. For example, financial reporting controls include controls over the completeness and accuracy of inventory records. Such controls are also necessary to provide complete and accurate inventory records to allow management to analyze and monitor inventory levels to better control operations and make procurement decisions (**operations** controls).
2. The five components of internal control and related principles defined in GAO’s *Standards for Internal Control in the Federal Government* (Green Book) relate to objectives that an entity strives to achieve in each of the three categories described above: financial reporting (including safeguarding), compliance, and operations controls. The components are as follows.[[26]](#footnote-27)

* **Control environment.** The foundation for an internal control system. It provides the discipline and structure to help an entity achieve its objectives.
* **Entity risk assessment.** Assesses the risks facing the entity as it seeks to achieve its objectives. This assessment provides the basis for developing appropriate risk responses.
* **Information and communication.** The quality information management and personnel communicate and use to support the internal control system.
* **Monitoring.** Activities management establishes and operates to assess the quality of performance over time and promptly resolve the findings of audits and other reviews.
* **Control activities.** The actions management establishes through policies and procedures to achieve objectives and respond to risks in the internal control system, which includes the entity’s information system.

1. During the planning phase, the auditor should understand and evaluate the design and implementation of the five components of internal control. Specific conditions that may indicate deficiencies in the control environment, entity risk assessment, information and communication, or monitoring components are provided in FAM 295 B. The understanding of specific control activities is discussed in FAM 340.[[27]](#footnote-28)
2. Based on AU-C 315.A111, the auditor’s understanding and evaluation of the five components of internal control provides a preliminary understanding of how the entity identifies risks relevant to financial reporting and how it responds to them. It may also influence the auditor’s identification and assessment of the risks of material misstatement in different ways (see FAM 265). For example:

* The auditor’s understanding of the control environment, entity risk assessment, and monitoring components is more likely to affect the identification and assessment of risks of material misstatement at the financial statement level.
* The auditor’s understanding of the information and communication component is more likely to affect the identification and assessment of risks of material misstatement at the assertion level, but it may also affect the identification and assessment of risks of material misstatement at the financial statement level.[[28]](#footnote-29)
* The auditor’s understanding of the control activities component is more likely to affect the identification and assessment of risks of material misstatement at the assertion level.

1. Based on the auditor’s understanding and evaluation of the design and implementation of the five components of internal control, the auditor should determine whether one or more control deficiencies have been identified (AU-C 315.31). If the auditor identified a deficiency, the auditor should determine whether (1) the deficiency is a material weakness, significant deficiency, or other control deficiency and (2) to report the deficiency in the auditor’s report or a separate report to management (see FAM 580).
2. The following discusses each internal control component in more detail, the effect of information technology on internal control, and other aspects of the entity’s internal control processes that the auditor should understand.

Control Environment

1. The auditor should evaluate the design of the control environment component and determine whether it has been implemented. The control environment is the foundation for an internal control system. It provides the discipline and structure, which affect the overall quality of internal control. It influences how objectives are defined and how control activities are structured. Those charged with governance and management establish and maintain an environment throughout the entity that sets a positive attitude toward internal control. The underlying principles for this component are as follows (Green Book):

* Those charged with governance and management should demonstrate a commitment to integrity and ethical values.
* Those charged with governance should oversee the entity’s internal control system.
* Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity’s objectives.
* Management should demonstrate a commitment to recruit, develop, and retain competent individuals.
* Management should evaluate performance and hold individuals accountable for their internal control responsibilities.

1. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity’s internal control and its importance in the entity (AU-C 315.A276). Based on AU-C 315.A276 and the Green Book, elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

* integrity, ethical values, and standards of conduct;
* commitment to competence;
* participation by those charged with governance;
* management’s philosophy and operating style;
* organizational structure;
* assignment of authority and responsibility;
* human resource policies and practices;
* management’s control methods over budget formulation and execution;
* management’s control methods over compliance with applicable laws, regulations, contracts, and grant agreements;
* documentation of the internal control system;
* succession and contingency plans and preparation; and
* enforcing accountability and considering excessive pressure.

1. Based on AU-C 315.21 and .42b, the auditor should, through performing risk assessment procedures, obtain and document an understanding of the control environment component and the underlying principles, relevant to the preparation of the financial statements, by
2. understanding the set of controls, processes, and structures that address

* how management’s oversight responsibilities are carried out, such as the entity’s culture and management’s commitment to integrity and ethical values;
* when those charged with governance are separate from management, the independence of, and oversight over the entity’s internal control by, those charged with governance;
* the entity’s assignment of authority and responsibility;
* how the entity attracts, develops, and retains competent individuals; and
* how the entity holds individuals accountable for their responsibilities in the pursuit of the objectives of internal control.

1. evaluating, based on the auditor’s understanding, whether

* management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior;
* the control environment provides an appropriate foundation for the other components of internal control, considering the nature and complexity of the entity; and
* control deficiencies identified in the control environment undermine the other components of internal control.

In making this evaluation, the auditor should obtain an understanding of the nature and extent of oversight and governance that the entity has in place over management’s financial reporting process relevant to accounting estimates (AU-C 540.12e and .A29).

1. In evaluating the design of the control environment and determining whether it has been implemented, the auditor determines whether the control environment enhances or mitigates the effectiveness of specific control activities (Green Book 10.03). In making this determination, the auditor should evaluate the following factors and their effect on internal control. For each factor listed below, FAM 295 B lists conditions that may indicate control environment deficiencies.
2. **Integrity, ethical values, and standards of conduct.** Control effectiveness cannot rise above the integrity and ethical values of those who create, administer, and monitor the controls. Management’s integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of the other components. Integrity and ethical behavior result when the entity’s leaders have high ethical and behavioral standards and properly communicate them and reinforce them in practice. The standards include management’s actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. Management also establishes a process for evaluating employees’ adherence to the organization’s standards of conduct and remediates any deviations timely and consistently (Green Book 1.10).

The communication of entity values and behavioral standards to personnel may take place through policy statements and codes of conduct and by example. Those charged with governance and management set the tone at the top and throughout the organization by their example, which is fundamental to an effective internal control system. Without a strong tone at the top to support an internal control system, the entity’s risk identification may be incomplete, risk responses may be inappropriate, control activities may not be designed or implemented effectively, information and communication may falter, and results of monitoring may not be understood or acted upon to remediate deficiencies (Green Book 1.02–1.05).

1. **Commitment to competence.** Competence is the knowledge and skills necessary to accomplish tasks required by an individual’s job. Commitment to competence includes management’s consideration of the competence levels for various jobs and the requisite skills, knowledge, and abilities, which are gained largely from professional experience, training, and certifications. Management establishes expectations of competence for key roles, and other roles at management’s discretion, to help the entity achieve its objectives. Management considers standards of conduct, assigned responsibility, and delegated authority when establishing expectations (Green Book 4.02–4.04). It is supplemented by effective human resources policies and practices, as discussed below.
2. **Participation by those charged with governance.** Those charged with governance are responsible for overseeing the financial reporting process, including internal control over financial reporting. This includes providing management with input for remediation and oversight of deficiencies in the internal control system as appropriate (Green Book 2.11–2.13). For a federal entity, those charged with governance may be members of a board or commission, an audit committee, the secretary of a cabinet-level department, OMB, the Department of the Treasury, or senior executives and financial managers responsible for the entity (Green Book 2.05). They oversee the entity’s operations, provide constructive criticism to management, and where appropriate make oversight decisions so that the entity achieves its objectives in alignment with the entity’s integrity and ethical values (Green Book 2.02 and 2.07). Capabilities expected of all members of those charged with governance include integrity and ethical values, leadership, critical thinking, and problem-solving abilities (Green Book 2.06). The effectiveness of those charged with governance is influenced by their authority and role in monitoring an entity’s financial reporting process.
3. **Management’s philosophy and operating style.** Management’s philosophy and operating style encompass a broad range of beliefs, concepts, and attitudes. Such characteristics may include management’s approach to taking and monitoring operational/program risks; attitudes and actions toward financial reporting; emphasis on meeting financial and operating goals; and attitude toward information processing, accounting, personnel, and internal control.
4. **Organizational structure.** An entity’s organizational structure provides the overall framework for planning, executing, directing, controlling, and assessing the organization’s operations in achieving its objectives. The organizational structure assigns authority and responsibility within the entity. An organizational structure includes the form and nature of an entity’s organizational units, including the data processing organization, and related management functions and reporting relationships, which are defined at all levels of the organization and provide methods of communication that can flow down, across, up, and around the structure. Management periodically evaluates the organizational structure so that it meets the entity’s objectives and has adapted to any new objectives for the entity, such as a new law or regulation (Green Book 3.02–3.05).
5. **Assignment of authority and responsibility.** An entity’s policies or procedures for assigning authority for operating activities and for delegating responsibility affect the understanding of established reporting relationships and responsibilities. These responsibilities are assigned to discrete units to enable the organization to operate in an efficient manner, comply with applicable laws and regulations, and reliably report quality information. Management determines the level of authority and delegates that authority only to the extent required to achieve the entity’s objectives. As part of delegating authority, management establishes the key roles and evaluates the delegation for proper segregation of duties within the unit and in the organizational structure (Green Book 3.06–3.08, 10.02, 10.03, 12.03, and 12.04). This factor includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resource allocations. It also includes policies and communications to enable personnel to understand the entity’s objectives, how they contribute to these objectives, and how and for what they will be held accountable. Management should periodically review policies, procedures, and related control activities for continued relevance and effectiveness in achieving the entity’s objectives or addressing related risks (Green Book 12.05).
6. **Human resource policies and practices.** Human resource policies and practices affect an entity’s ability to employ sufficient competent and trustworthy personnel to accomplish its goals and objectives. Such policies and practices include hiring, training, evaluating, promoting, compensating, mentoring, retaining, and assisting employees in performing their assigned responsibilities by giving them the necessary resources (Green Book 4.05).
7. **Management’s control methods over budget formulation and execution.** Management’s budget control methods affect the authorized use of appropriated funds. Budget formulation is discussed in more detail in FAM 260.55, and controls over budget execution (budget controls) are addressed in more detail in FAM 300.
8. **Management’s control methods over compliance with laws, regulations, contracts, and grant agreements.** Such methods have a direct effect on an entity’s compliance with applicable laws, regulations, contracts, and grant agreements. Compliance controls are addressed in more detail in FAM 300.
9. **Documentation of the internal control system.** Management develops and maintains documentation of its internal control system to meet organizational needs by establishing and communicating the who, what, when, where, and why of internal control execution to personnel through its policies. The extent of documentation needed to support the design, implementation, and operating effectiveness of the five components of internal control is a matter of management judgment (Green Book 3.09–3.12 and 12.02).
10. **Succession and contingency plans and preparation.** Management defines succession and contingency plans for key roles to help the entity continue achieving its objectives. Succession plans address the entity’s need to replace competent personnel over the long term, whereas contingency plans address the entity’s need to respond to sudden personnel changes that could compromise the internal control system. The importance of a key role in the internal control system and the impact to the entity of its vacancy dictate the formality and depth of the contingency plan (Green Book 4.06–4.08).
11. **Enforcing accountability and considering excessive pressure.** Management enforces accountability for individuals in performing their internal control responsibilities. Management holds personnel accountable through mechanisms such as performance appraisals and disciplinary actions. Management also holds service organizations accountable for their assigned internal control responsibilities. Management communicates to the service organization the objectives of the entity and their related risks, the entity’s standards of conduct, the role of the service organization in the organizational structure, the assigned responsibilities and authorities of the role, and the expectations of competence for its role that will enable the service organization to perform its internal control responsibilities. Management, with oversight from those charged with governance, takes corrective action as necessary to enforce accountability for internal control in the entity (Green Book 5.02–5.06). Management is responsible for evaluating pressure on personnel to help personnel fulfill their assigned responsibilities in accordance with the entity’s standards of conduct. Management adjusts excessive pressures on personnel in the entity. Pressure can appear in an entity because of goals management established to meet objectives or cyclical demands of various processes the entity performs (Green Book 5.07–5.08).

Entity Risk Assessment

1. The auditor should evaluate the design of the entity risk assessment component and determine whether it has been implemented. Management assesses the risks the entity faces from both external and internal sources. This assessment provides the basis for developing appropriate risk responses. The underlying principles for this component are as follows (Green Book):

* Management should define objectives clearly to enable the identification of risks and define risk tolerances.
* Management should identify, analyze, and respond to risks related to achieving the defined objectives.
* Management should consider the potential for fraud when identifying, analyzing, and responding to risks.
* Management should identify, analyze, and respond to significant changes that could impact the internal control system.

1. Based on AU-C 315.A276, the entity’s risk assessment process is an iterative process for identifying and analyzing risks to achieving the entity’s objectives. It also forms the basis for how management or those charged with governance determine the risks to be managed. The entity’s risk assessment process includes how management

* identifies risks relevant to the preparation of the financial statements (including safeguarding of assets) and compliance with laws (including those governing the use of budget authority), regulations, contracts, and grant agreements;
* estimates their significance;
* assesses the likelihood of their occurrence; and
* decides on actions to manage them and the results thereof.

For example, the entity’s risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements or considers the risks of fraud.

1. Risks relevant to reliable financial reporting include external and internal events, transactions, or circumstances that may occur and adversely affect an entity’s ability to initiate, record, process, and report financial information consistent with the assertions of management in the financial statements. Based on AU-C 315.A276 and the Green Book, risks can arise or change due to circumstances, such as

* changes in the economic, operating, regulatory, or statutory environment;
* new personnel who may have a different focus on or understanding of the entity’s internal control;
* the ability of management to override established controls;
* new or revamped information systems;
* rapid growth of programs, which can strain controls;
* new technology, which may change risks;
* new programs or activities, which may introduce new control risks;
* restructurings or budget cutbacks, which may include downsizing and changes in supervision and segregation of duties;
* adoption of new accounting principles or changing accounting principles, which may affect risks in preparing financial statements;
* use of information technology; or
* environmental, social, and governance issues.

1. Based on AU-C 315.22, 315.42b, and 540.12g, the auditor should, through performing risk assessment procedures, obtain and document an understanding of the entity risk assessment component, and the underlying principles relevant to the preparation of the financial statements, by

* understanding the entity’s process for

identifying risks, including those relating to accounting estimates and the potential for fraud, relevant to financial reporting objectives (including safeguarding and its service organizations) and its compliance with budget and other laws, regulations, contracts, and grant agreements;

assessing the significance of those risks, including the likelihood of their occurrence; and

addressing those risks.

* evaluating whether the entity’s risk assessment process is appropriate to the entity’s circumstances, considering the nature and complexity of the entity.

1. In evaluating the design of the entity risk assessment component and determining whether it has been implemented, the auditor should understand whether management defines objectives clearly in specific and measurable terms to enable the design of internal control for related risks to be understood at all levels of the entity. Within the objectives, management defines the risk tolerances, which are the acceptable levels of variation in performance relative to the achieving objectives. Depending on the category of objectives, risk tolerances may be expressed as operations objectives, nonfinancial reporting objectives, financial reporting objectives, or compliance objectives (Green Book 6.02–6.10).
2. If the auditor identifies risks of material misstatement that management failed to identify, the auditor should

determine whether any such risks are of a kind that the auditor expects would have been identified by the entity’s risk assessment process and, if so, obtain an understanding of why the entity’s risk assessment process failed to identify such risks of material misstatement and

consider the implications for the auditor’s evaluation of whether the entity’s risk assessment process is appropriate to the entity’s circumstances (AU-C 315.23).

Information and Communication

1. The auditor should evaluate the design of the information and communication component and determine whether it has been implemented.[[29]](#footnote-30) Management uses quality information to support the internal control system. Effective information and communication are vital for an entity to achieve its objectives. Entity management needs access to relevant and reliable communication related to internal as well as external events. The underlying principles for this component are as follows (Green Book):

* Management should use quality information to achieve the entity’s objectives.
* Management should internally communicate the necessary quality information to achieve the entity’s objectives.
* Management should externally communicate the necessary quality information to achieve the entity’s objectives.

1. Management identifies information requirements needed to achieve the entity’s objectives and to address related risks. Based on the identified information requirements, management obtains relevant data from reliable internal and external sources in a timely manner. Management processes relevant data into quality information, within the entity’s information system, that supports the internal control system. Management uses quality information to make informed decisions and evaluate the entity’s performance in achieving key objectives and addressing risks. Quality information is appropriate, current, complete, accurate, accessible, and provided on a timely basis (Green Book 13.02–.06).
2. Communication includes providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Management communicates quality information down and across reporting lines to enable personnel to perform key roles in achieving objectives, addressing risks, and supporting the internal control system. Open communication channels provide a means to report exceptions to the appropriate people, including management and those charged with governance (Green Book 14.02–14.06).
3. Management communicates with, and obtains quality information from, external parties using established reporting lines so that external parties can help the entity achieve its objectives and address related risks. Open two-way external reporting lines allow for this communication. Information communicated to management and those charged with governance includes significant matters relating to risks, changes, or issues that impact the entity’s internal control system (Green Book 15.02–15.06 and 13.02).
4. Management considers a variety of factors, such as audience, nature of information, availability, cost, and legal or regulatory requirements, in selecting an appropriate method of communication. Communication takes such forms as websites, emails, policy manuals, accounting and financial reporting manuals, and memorandums. Communication also may be electronic, oral, and through the actions of management in demonstrating acceptable behavior (Green Book 14.07–14.08). Laws and regulations may require entities to establish separate lines of communication, such as whistleblower and ethics hotlines, for communicating confidential information. Management informs employees of these separate reporting lines, how they operate, how they are to be used, and how the information will remain confidential (Green Book 14.06).
5. Based on AU-C 315.25a and .42b, the auditor should, through performing risk assessment procedures, obtain and document an understanding of the information and communication component and the underlying principles, relevant to the preparation of the financial statements. In connection with this understanding, the auditor should obtain an understanding of the entity’s information system, including its information processing and data, the resources to be used in such activities and the policies that define, for material line items, accounts, note disclosures, and classes of transactions,
6. how information flows through the entity’s information system, including how
   * + transactions are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated into the general ledger, and reported in the financial statements and
     + information about events and conditions, other than transactions, is captured, processed, and disclosed in the financial statements;
7. the accounting records, specific accounts in the financial statements, and other supporting records relating to the flows of information in the information system;
8. the financial reporting process used to prepare the entity’s financial statements, including note disclosures; and
9. the entity’s resources, including information technology,[[30]](#footnote-31) relevant to the preceding items.
10. The auditor should also obtain an understanding of the entity’s information system as it relates to accounting estimates, including the following (AU-C 540.12h:
11. How information relating to accounting estimates and related note disclosures for material line items, accounts, note disclosures, and classes of transactions flows through the entity’s information system.
12. For such accounting estimates and related note disclosures, how management
    * identifies the relevant methods, assumptions, or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework (generally U.S. GAAP), including how management
      + - * selects or designs, and applies, the methods used, including the use of models,
          * selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions, and
          * selects the data to be used;

* understands the degree of estimation uncertainty, including by considering the range of possible measurement outcomes; and
* addresses the estimation uncertainty, including selecting a point estimate and related note disclosures for inclusion in the financial statements.

1. Based on AU-C 315.25b, the auditor should obtain an understanding of how the entity communicates significant matters that support the (1) preparation of the financial statements, including safeguarding of assets and compliance with laws (including those governing the use of budget authority), regulations, contracts, and grant agreements, and (2) related responsibilities in the information and communication component and other components of internal control
   * between people within the entity, including how financial reporting roles and responsibilities are communicated;
   * between management and those charged with governance; and
   * with external parties, such as those with regulatory authorities and service organizations.
2. The auditor should evaluate, based on the auditor’s understanding obtained in the preceding paragraphs, whether the entity’s information and communication component appropriately supports the preparation of the entity’s financial statements in accordance with the applicable financial reporting framework (generally U.S. GAAP), considering the nature and complexity of the entity (AU-C 315.25c).

Monitoring

1. The auditor should evaluate the design of the monitoring component and determine whether it has been implemented. Internal control monitoring assesses the quality of performance over time and promptly resolves the findings of audits and other reviews. Corrective actions are a necessary complement to control activities in order to achieve objectives. The underlying principles for this component are as follows (Green Book):

* Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.
* Management should remediate identified internal control deficiencies on a timely basis.

1. Monitoring is the process by which management and those charged with governance assess the effectiveness of internal control performance over time. This may include establishing a baseline; ongoing activities, such as regular management and supervision, to determine that a control was performed correctly and evaluating the results; or communications from external parties, such as regulator comments that may indicate areas in need of improvement (Green Book 16.02–16.03).
2. Monitoring may include separate evaluations, such as FMFIA and FFMIA assessments and IG or internal auditor work, or a combination of ongoing activities and separate evaluations (see FMFIA and FFMIA sections below for further discussion). Ongoing monitoring is built into the entity’s operations, is performed continually, and responds to change. Separate evaluations are used periodically and may provide feedback on the effectiveness of ongoing monitoring. Separate evaluations also include audits and other evaluations that may involve the review of control design and direct testing of internal control. Management evaluates and documents the results of ongoing monitoring and separate evaluations to identify internal control issues (Green Book 16.04–16.09).
3. Some entities have an internal audit function, which is often an important part of monitoring. Internal audit (1) provides information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control; (2) communicates information about strengths and deficiencies in internal control; and (3) provides recommendations for improving internal control. If the internal audit function is part of the entity’s monitoring controls, the auditor should understand the design and implementation of the internal audit function as a monitoring control. Understanding an internal audit function includes considering its authority and reporting relationships, the qualifications of its staff, and its resources. For information on using the work of internal auditors, see FAM 645.
4. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. For example, management may use information from the IG’s office to aid in monitoring. The IG’s office (a) conducts audits and investigations relating to programs and operations; (b) provides oversight and coordination, including recommending policies for programs and operations; and (c) keeps the entity head and the Congress informed about problems and deficiencies, including the progress of corrective actions. If using information from the IG’s office is part of the entity’s monitoring controls, the auditor should understand the design and implementation of this as a monitoring control (Green Book 16.10).
5. Effective monitoring includes evaluating any internal control deficiencies identified and remediating those deficiencies timely. This may be accomplished through establishing reporting lines to the appropriate internal and external parties on a timely basis to enable prompt evaluation of those issues. For example, personnel may communicate these issues internally to the person in the key role responsible for the internal control or associated process and, when appropriate, to at least one level of management above that individual. Depending on the nature of the issues, personnel may consider reporting certain issues to those charged with governance. Management determines based on the type of internal control deficiency the appropriate corrective actions to remediate the internal control deficiency on a timely basis (Green Book 17.01–17.05). This includes completing and documenting the corrective actions on a timely basis. These corrective actions include resolution of audit findings (Green Book 17.06).
6. Based on AU-C 315.24 and .42b, the auditor should, through performing risk assessment procedures, obtain and document an understanding of the monitoring component and the underlying principles, relevant to the preparation of the financial statements, by
   * + - 1. understanding those aspects of the entity’s process that address

ongoing and separate evaluations for monitoring the effectiveness of controls, including safeguarding controls and controls over compliance with laws (including those governing the use of budget authority), regulations, contracts, and grant agreements, and the identification and remediation of control deficiencies identified and

the entity’s internal audit function, if any, including its nature, responsibilities, and activities.

* + - * 1. understanding the sources of the information used in the entity’s process to monitor internal control, and the basis upon which management considers the information to be sufficiently reliable for the purpose.
        2. evaluating, based on the auditor’s understanding obtained above, whether the entity’s process for monitoring internal control is appropriate to the entity’s circumstances considering the nature and complexity of the entity.

Control Activities

1. Control activities are the actions management establishes through policies and procedures to achieve objectives and respond to risks in the internal control system, which includes the entity’s information system. The underlying principles for this component are as follows (Green Book):

* management should design the entity’s control activities to achieve objectives and respond to risks,
* management should design the entity’s information system and related control activities to achieve objectives and respond to risks, and
* management should implement control activities through policies.

1. Based on AU-C 315.26, the auditor should, through performing risk assessment procedures, obtain and document an understanding of the control activities component and the underlying principles relevant to the preparation of the financial statements. The auditor’s understanding of specific control activities is obtained in the internal control phase and discussed in FAM 300. In the planning phase, the auditor may obtain an understanding of the control activities component through inquiries with management regarding any changes in this component from the prior year and review of high-level documents that the entity has prepared related to control activities.

Effect of Information Technology on Internal Control

1. The auditor should obtain an understanding of the entity’s information technology environment sufficient for assessing the risks of material misstatement and planning the audit. The information technology environment consists of the information technology applications and supporting information technology infrastructure, as well as the information technology processes and personnel involved, that an entity uses to support its operations and achieve strategic objectives (AU-C 315.12). The auditor should identify aspects of the entity’s information technology environment relevant to material line items, accounts, note disclosures, and classes of transactions that are subject to risks arising from the use of information technology.
2. The information technology environment affects the effectiveness of the five components of internal control. For example, controls that normally would be performed by separate individuals in manual systems may be concentrated in one software program or application and pose a potential segregation-of-duties issue. See AU-C 315.A278 for further discussion of the effect of information technology on internal control.
3. The auditor should evaluate the following factors in assessing the effect of information technology on the five components of internal control. An IS controls auditor may assist the auditor in considering these factors.
4. **Management’s attitudes and awareness with respect to information technology.** Management’s interest in and awareness of information technology functions (including those performed for the entity by other organizations) is important in establishing an organization-wide consciousness of control issues. Management may demonstrate its interest and awareness by
   * considering the risks and benefits of software programs;
   * communicating policies regarding information technology functions and responsibilities;
   * overseeing policies and procedures for developing, modifying, maintaining, and using computers, and for controlling access to programs and files;
   * considering the risks of material misstatement, including fraud risk, related to information technology;
   * responding to previous recommendations or concerns;
   * quickly and effectively planning for, and responding to, information technology crises; and
   * using reliable computer-generated information for key operating decisions.
5. **Organization and structure of the information technology function.** The organizational structure of the information technology function affects the control environment. Centralized structures often have a single computer-processing organization and use a single set of system and software programs, enabling tighter management control over information technology. In decentralized structures, each computer center generally has its own computer-processing organization, software programs, and system software, which may result in differences in policies and procedures and various levels of compliance at each location.
6. **Clearly defined assignment of responsibilities and authority.** Appropriate assignment of responsibility according to typical information technology functional areas can affect the control environment. Factors to consider include
   * how the position of Chief Information Officer fits into the organizational structure;
   * whether duties are appropriately segregated within the information technology function, such as those of operators and programmers, since lack of segregation typically affects all systems;
   * the extent to which management external to the information technology function is involved in major systems development decisions; and
   * the extent to which information technology policies, standards, and procedures are documented, understood, followed, and enforced.
7. **Management’s ability to identify and to respond to potential risk.** Information technology, by its nature, introduces additional risk factors. The entity should be aware of these risks and should develop appropriate policies and procedures to respond to any information technology issues that might occur. The auditor may evaluate
   * the methods for monitoring incompatible functions and for enforcing segregation of duties and
   * management’s mechanism for identifying and responding to unusual or exceptional conditions timely.

Federal Managers’ Financial Integrity Act of 1982

1. FMFIA requires executive agencies to establish internal controls that reasonably ensure that
   * obligations and costs comply with applicable law;
   * all assets are safeguarded against waste, loss, unauthorized use, and misappropriation; and
   * revenues and expenditures applicable to agency operations are recorded and accounted for properly so that accounts and reliable financial and statistical reports may be prepared and accountability of the assets may be maintained.[[31]](#footnote-32)

The Comptroller General issues standards for internal control in the federal government pursuant to FMFIA. GAO’s *Standards for Internal Control in the Federal Government* (Green Book) provides the overall framework for establishing and maintaining an effective internal control system and provides management criteria for designing, implementing, and operating an effective internal control system.

1. FMFIA also requires executive agencies to evaluate and report on whether the agencies’ internal control systems comply with the requirements described in the paragraph above. OMB Circular No. A-123, *Management’s Responsibility for Enterprise Risk Management and Internal Control*, provides implementation guidance for complying with this requirement. The circular defines management’s responsibilities related to internal control and the process for assessing and reporting on the effectiveness of internal control over operations, reporting, and compliance.
2. If applicable to the entity, the auditor should obtain an understanding of the entity’s process for assessing and reporting on the effectiveness of internal control based on criteria established under FMFIA (referred to as the FMFIA process) and whether the process has been implemented. The auditor should then determine whether this understanding affects the auditor’s risk assessment.
3. The effectiveness of the FMFIA process typically is a good indicator of management’s (1) philosophy and operating style, (2) assignment of authority and responsibility, and (3) control methods for monitoring and follow-up. The FMFIA process also may be the basis for management’s assessment about the effectiveness of internal control over financial reporting and about the entity’s financial management systems’ substantial compliance with FFMIA requirements.
4. To obtain an understanding of the FMFIA process, the auditor generally should perform the following procedures. If the entity does not issue its own FMFIA report, the auditor generally should perform the following procedures with respect to information the entity contributes to the FMFIA report in which the entity is included.
5. Read the following:
   * FMFIA reports for the current and prior years to identify any changes;
   * important documentation prepared by the entity to support the current-year FMFIA report and related management assertions in the Management’s Discussion and Analysis (MD&A);
   * any IG reports on the FMFIA process;
   * OMB’s most recent annual letter concerning FMFIA reporting; and
   * management’s description of the FMFIA process.
6. Discuss the FMFIA process with appropriate entity management (including management’s opinion of the quality of the process), specifically

* how the FMFIA process is organized;
* who is assigned to manage the process, including the staffing level, experience and qualifications of assigned personnel, and reporting responsibilities; and
* how the process finds and evaluates deficiencies.

1. Identify the entity’s actions on previously reported deficiencies and examine its documentation that demonstrates the results/effectiveness of those actions.
2. Determine whether the audit finds different issues from those identified in the FMFIA process (if so, see FAM 580.85 for reporting on FMFIA).
3. The auditor should consider whether management procedures and supporting documentation are designed to provide management with reasonable assurance that FMFIA objectives have been achieved. The auditor’s consideration is based on the auditor’s understanding of the procedures discussed above rather than the results of extensive tests. Factors the auditor may consider include

* evidence of efforts to rectify previously identified material weaknesses;
* management’s commitment of resources to the FMFIA process, as reflected in the skills, objectivity, and number of personnel assigned to manage the process;
* extent to which management’s methodology and assessment process, including testing and documentation, conform to the guidance in OMB Circular No. A-123 and related appendixes;
* contractor or internal auditor involvement (if any);
* the process used to identify and screen material weaknesses as FMFIA reports are consolidated and moved up the entity’s hierarchy;
* the sources that identify material weaknesses, since items identified by management personnel, rather than information from IG, GAO, or other external reports, demonstrate that the process can detect and report deficiencies;
* the extent to which management’s FMFIA reports are consistent with the auditor’s findings; and
* risk factors in FAM 295 B.20.

1. The auditor should document the understanding of the FMFIA process and its implementation. Based on this understanding, the auditor should determine whether this understanding affects the auditor’s risk assessment. The auditor should consider any material weaknesses identified in the FMFIA report in assessing the risks of material misstatement.

The auditor is not required to test the effectiveness of the FMFIA process. However, the auditor may determine that it is appropriate to test management’s FMFIA work to reduce audit risk. The auditor’s determination, based on testing, that FMFIA is an effective control may reduce but cannot completely eliminate the need for the auditor to perform substantive procedures for material line items, accounts, note disclosures, and classes of transactions. FAM 360 discusses control testing, and FAM 370 discusses the preliminary assessments of control risk and the risk of material misstatement.

Internal Control over Financial Reporting

1. The auditor should obtain an understanding of the entity’s process for assessing the effectiveness of its internal control over financial reporting. Management is responsible for the design, implementation, and maintenance of internal control over financial reporting. An entity should have a reasonable basis supporting management assertions on the effectiveness of internal control over financial reporting. As discussed in the Green Book, an effective internal control system has

* each of the five components of internal control designed, implemented, and operating effectively and
* the five components operating together in an integrated manner.

1. In order to obtain an understanding of the entity’s system of internal control over financial reporting, the auditor may perform the following procedures:
   * Determine whether the entity established and organized an appropriate internal control over financial reporting management team.
   * Determine whether the entity documented its methodology and plan for its internal control over financial reporting process, including an entity risk assessment.
   * Review documentation from the entity’s prior assessments of internal control over financial reporting.
2. In obtaining an understanding, the auditor should consider whether management procedures and supporting documentation are designed to provide management with reasonable assurance about the effectiveness of the entity’s internal control over financial reporting. This consideration should include risk factors in FAM 295 B.21.

The auditor should consider any material weaknesses identified by management’s assessment of internal control over financial reporting in determining the risks of material misstatement. FAM 270 discusses determining the likelihood of effective information system controls (IS controls), FAM 360 discusses control testing, and FAM 370 discusses the preliminary assessments of control risk and the risk of material misstatement.

Federal Financial Management Improvement Act of 1996

1. As part of its FFMIA work, management determines whether its financial management systems adhere to the guidance found in OMB Circular No. A-123, appendix D, *Management of Financial Management Systems – Risk and Compliance*,and the *Treasury Financial Manual,* volume 1, part 6, chapter 9500, *Revised Federal Financial Management System Requirements*. Under FFMIA, the auditor of CFO Act agencies must report whether the financial management systems comply substantially with the three requirements of the act. OMB issues guidance for agencies and auditors when addressing compliance with FFMIA. FAM 701 contains additional guidance for auditors.
2. During the planning phase, the auditor should understand the design of management’s process for determining whether the entity’s financial management systems were in substantial compliance to report under FFMIA. OMB Circular No. A-123 and the *Treasury Financial Manual* provide criteria for assessing FFMIA compliance. The auditor generally should read management’s documentation to determine whether to rely on the entity’s work. If reliance is planned, see FAM 645. See FAM 350 for additional planning of audit procedures related to FFMIA.
3. If the entity previously had an assessment made of its financial management systems’ substantial compliance with these requirements that resulted in finding lack of substantial compliance, the auditor should understand the systems deficiencies identified and consider their effect on the risks of material misstatement. The auditor also should read the remediation plan required by FFMIA and note whether the plan appears feasible and likely to remedy the deficiencies.

Federal Information Security Modernization Act of 2014

1. The Federal Information Security Modernization Act of 2014 (FISMA) amended the Federal Information Security Management Act of 2002. FISMA requires federal agencies to periodically test, evaluate, and report on the effectiveness of their information security policies, procedures, and practices as part of developing and implementing an entity-wide information security program. FISMA requires agencies to use the National Institute of Standards and Technology’s (NIST) standards when performing certain functions. OMB reporting guidance for FISMA specifies the applicable NIST standards and other NIST publications to be used.
2. FISMA requires agencies to perform an independent evaluation and submit an annual report regarding major information security incidents to OMB, the Department of Homeland Security, and GAO. These annual reports should include (1) threats and threat actors, vulnerabilities, and impacts; (2) agency risk assessments of affected systems before, and the status of compliance of the systems with security requirements at the time of, major incidents; (3) detection, response, and remediation actions; (4) the total number of incidents, including system implementation levels and locations of affected incidents; and (5) a description of the number of individuals affected by, and the information exposed by, major incidents involving a breach of personally identifiable information. Agencies are also required to have their information security programs evaluated each year by their IG or by an independent external auditor. An external auditor may be engaged by an IG or, if the agency does not have an IG, by the agency. Management may rely on testing performed as part of the independent evaluation when making its own assessment.
3. The auditor should read the most recent FISMA report to assess the implications of any reported threats, incidents, and vulnerabilities on the risks of material misstatement. The auditor may assess whether the procedures performed for FISMA reporting can be relied upon as part of the financial statement audit for purposes of planning and conducting other audit procedures. Likewise, it may be possible for the auditor to use procedures performed as part of the financial statement audit to fulfill the FISMA requirements for certain systems, depending on the timing, nature, and extent of the work.

Budget Formulation

1. The auditor should obtain an overall understanding of the design of the budget formulation process. The auditor does this to understand better how misstatements and internal control deficiencies may affect the budget formulation process. Based on discussions with entity management responsible for the budget formulation process and review of budget documents, the auditor should understand the design of

* the entity’s process for developing and summarizing the budget;
* the nature and sufficiency of instructions and training provided to individuals responsible for developing the budget;
* the extent to which individuals involved in approving budget requests are also involved in the budget formulation process;
* the general extent to which the budget is based on historical information;
* the reliability of information on which the budget is based;
* the extent to which the budget formulation system is integrated with the budget execution system; and
* the correlation between information developed in the budget formulation process and the allotments and suballotments, if applicable, in the budget execution system.

1. The auditor is not required to test the effectiveness of the budget formulation process, unless the auditor determines in the internal control phase that testing the effectiveness of the budget formulation process is an efficient and effective means of reducing the risk of material misstatement and the extent of substantive procedures.

265 – Identify Risks of Material Misstatement and Assess Inherent Risk

Audit Risk

1. AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, provides guidance on audit risk and defines it as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is composed of the following risks:
   1. **Risk of material misstatement** is the risk that prior to the audit, the financial statements are materially misstated due to fraud or error. The components of risk of material misstatement are described below.
   * **Inherent risk** is the susceptibility of an assertion about a line item, account, note disclosure, or class of transactions to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related control activities (AU-C 200.14).
   * **Control risk** is the risk that a misstatement that could occur in an assertion about a line item, account, note disclosure, or class of transactions and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control (AU-C 200.14). Control risk is a function of the effectiveness of the design and operation of internal control in achieving the entity’s objectives relevant to preparation and fair presentation of the entity’s financial statements. Some control risk will always exist because of the inherent limitations of internal control.
   1. **Detection risk** is the risk that the procedures the auditor performs to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements (AU-C 200.14). Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor (AU-C 200.A50). Detection risk relates to the substantive procedures and is managed by the auditor’s response to the risk of material misstatement.
2. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, the auditor should obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion (AU-C 200.06 and .19).
3. Audit assurance is the complement of audit risk and equals 100 percent minus the allowable audit risk.[[32]](#footnote-33) The audit organization should determine the audit assurance to use, which may vary between audits based on risk. GAO auditors should use an audit assurance of 95 percent. In other words, the GAO auditor, in order to provide an opinion, should design the audit to achieve at least 95 percent audit assurance that the financial statements are not materially misstated (5 percent audit risk). FAM 470 provides guidance on how to combine (1) the risk of material misstatement and (2) detection risk for substantive procedures to achieve the audit assurance required by the audit organization.
4. The auditor may consider it necessary to achieve increased audit assurance if the entity is politically sensitive or if the Congress has expressed concerns about the entity’s financial reporting. In these cases, the basis for the increased level of audit assurance must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved.
5. Based on the level of audit risk and the risk of material misstatement, the auditor should determine the nature, extent, and timing of substantive procedures necessary to achieve the acceptable level of detection risk. For example, in response to a high risk of material misstatement, the auditor may perform

* additional substantive procedures that provide more appropriate evidence (nature of procedures);
* more extensive substantive procedures (extent of procedures), as discussed in FAM 295 E; or
* substantive procedures at or closer to the financial statement date (timing of procedures).

Brainstorming About the Risks of Material Misstatement

1. The engagement partner (typically the audit director) and other key engagement team members should discuss (brainstorm about) the application of the applicable financial reporting framework (generally U.S. GAAP) and the susceptibility of the entity’s financial statements to material misstatement (AU-C 315.17). The discussion accomplishes the following (AU-C 315.A49):

* Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity. Sharing information contributes to an enhanced understanding by all engagement team members.
* Allows the engagement team members to exchange information about the risks to which the entity is subject; how inherent risk factors may affect the susceptibility of line items, accounts, note disclosures, and classes of transactions to misstatement; and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
* Assists the engagement team members in gaining a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them and to understand how the results of the audit procedures that they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures. In particular, the discussion assists engagement team members in further considering contradictory information based on each member’s own understanding of the nature and circumstances of the entity.
* Provides a basis on which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

Depending on the circumstance of the audit, multiple discussions may be held to facilitate the ongoing exchange of this information among team members. The purpose of these discussions is to share information obtained throughout the audit that may affect the auditor’s risk assessments or related audit procedures.

1. As required by AU-C 240.15, this discussion should include an exchange of ideas, or brainstorming, among the engagement team members about how and where the entity’s financial statements (including the individual statements and note disclosures) might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. During the discussion, engagement team members should set aside beliefs that they may have that management and those charged with governance are honest and have integrity, and should, in particular, also address

* known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud;
* the risk of management override of controls;
* consideration of circumstances that might be indicative of earnings management or manipulation of other financial measures and the practices that might be followed by management to manage earnings or other financial measures that could lead to fraudulent financial reporting;
* the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement due to fraud (see FAM 110.25); and
* how the auditor might respond to the susceptibility of the entity’s financial statements to material misstatement due to fraud (AU-C 240.15).

1. During the brainstorming, the auditor should include specific consideration of the susceptibility of the financial statements to material misstatement due to error or fraud that could result from the entity’s relationships and transactions with disclosure entities, related parties, and public-private partnerships (AU-C 550.13). The auditor may discuss matters such as (1) the nature and extent of these relationships and transactions; (2) the records or documents that may indicate the existence of these relationships or transactions; and (3) how disclosure entities, related parties, and public-private partnerships may be involved in fraud. See AU-C 550.A7 through .A8 for additional matters that may be discussed.
2. Key members of the engagement team should be involved in this discussion; however, it is not necessary for all team members to have a comprehensive knowledge of all aspects of the audit. The auditor should use professional judgment to determine the meeting participants (including any specialists), the number of meetings, how and when the meetings should occur, and the extent of the discussion. The roles, experience, and information needs of the engagement team are factors that influence the extent of the discussion.
3. When there are engagement team members not involved in the engagement team discussion, the engagement partner should determine which matters to communicate to those members (AU-C 315.18). For example, if separate discussions are held with the key staff at various locations for a multilocation audit, it is not necessary for all members of the engagement team to be informed of all the decisions reached in the discussion.

Identify Risks of Material Misstatement

1. The auditor should identify the risks of material misstatement due to fraud or error and determine whether they exist at the
2. financial statement level or
3. assertion level for line items, accounts, note disclosures, and classes of transactions (AU-C 315.32).

A risk of material misstatement exists when

* there is a reasonable possibility of a misstatement occurring (i.e., its likelihood) and
* if it were to occur, there is a reasonable possibility of the misstatement being material (i.e., its magnitude).

There is a reasonable possibility when the likelihood of a material misstatement occurring is more than remote. (AU-C 315.A12)

Risks of Material Misstatement at the Financial Statement Level

1. Risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the line item, account, note disclosure, or class of transactions level. Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level. (AU-C 315.A224) Risks of material misstatement at the financial statement level affect the auditor’s design of overall responses, as discussed in FAM 420 and AU-C 330.A1 through .A2, including an influence on the nature, timing, and text of further audit procedures (AU-C 315.A114).
2. Based on AU-C 315.A225 through .A227, the auditor should consider the following in identifying risks of material misstatement at the financial statement level:

* risks related to the political climate, public interest, and sensitivity of programs or activities;
* fraud risks, including management override of control; and
* risks related to the entity’s internal control, in particular, the control environment, entity risk assessment, information and communication, and monitoring components (see FAM 260).

1. Based on AU-C 315.A275, events or conditions that may indicate risks of material misstatement at the financial statement level include

* lack of personnel with appropriate accounting and financial reporting skills;
* past misstatements, history of errors, or a significant amount of adjustments at period-end; and
* control deficiencies, particularly in the control environment, entity risk assessment, information and communication, and monitoring components, and especially those not addressed by management (see FAM 260).

Deficiencies in the operation of these four components could have pervasive effects on the preparation of the financial statements because these components are foundational to the entity’s internal control.

Risks of Material Misstatement at the Assertion Level

1. Risks of material misstatement at the assertion level are those that do not relate pervasively to the financial statements (AU-C 315.A231). For each applicable assertion in each material line item, account, note disclosure, and class of transactions identified in FAM 235, the auditor should identify the related risks of material misstatement.
2. Based on the auditor’s understanding of the entity and its environment, the applicable financial reporting framework (generally U.S. GAAP), and the entity’s accounting policies, the auditor should tailor the potential misstatements in FAM 395 B to the specific circumstances of the entity. The auditor may identify multiple types of potential misstatements in an assertion. Some types of potential misstatements may affect only a portion or component of a line item, account, note disclosure, or class of transactions. These potential misstatements represent identified risks of material misstatement at the assertion level.
3. The auditor should document the identified risks of material misstatement at the assertion level for each material line item, account, note disclosure, and class of transactions on the LIRA form at FAM 395 H or equivalent.
4. The auditor may conclude that some risks of material misstatement identified at the assertion level relate more pervasively to the financial statements as a whole and potentially affect many assertions, in which case, the auditor may update the identification of risks of material misstatement at the financial statement level (AU-C 315.A245).

Assess and Respond to Risks of Material Misstatement at the Financial Statement Level

1. For identified risks of material misstatement at the financial statement level, the auditor should assess the risks and

* determine whether they affect the assessment of risks at the assertion level and
* evaluate the nature and extent of their pervasive effect on the financial statements (AU-C 315.34).

For example, management override of controls is a risk that resides at the financial statement level but may also relate to the overstatement of revenue.

1. The auditor should design and implement overall responses to address the risks of material misstatement at the financial statement level (AU-C 330.05). See FAM 420.02 for further guidance.
2. The auditor should document in the audit strategy the identification and assessment of risks of material misstatement at the financial statement level and the overall responses to such risks.

Assess and Respond to Inherent Risk for Identified Risks of Material Misstatement at the Assertion Level

Assess Inherent Risk

1. For each identified risk of material misstatement at the assertion level, the auditor should assess inherent risk by assessing the likelihood and magnitude of misstatement before consideration of any related control activities.[[33]](#footnote-34) In doing so, the auditor should take into account how, and the degree to which,
2. inherent risk factors identified in FAM 220 affect the susceptibility of assertions to misstatement and
3. the risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level. (AU-C 315.35)
4. For each identified risk of material misstatement at the assertion level in each material line item, account, note disclosure, and class of transactions, the auditor should assess inherent risk at one of four levels:

* **Remote:** The auditor believes, before consideration of control activities, that the likelihood of a material misstatement occurring in the assertion is less than reasonably possible.
* **Low:** The auditor believes, before consideration of control activities, that it is **unlikely** that any aggregate misstatements in the assertion exceed performance materiality.
* **Moderate:** The auditor believes, before consideration of control activities, that it is **more than unlikely but less than likely** that any aggregate misstatements in the assertion exceed performance materiality.
* **High:** The auditor believes, before consideration of control activities, that it is **likely** that any aggregate misstatements in the assertion exceed performance materiality.

Low, moderate, and high are varying levels of likelihood that are reasonably possible and represent the spectrum of inherent risk.[[34]](#footnote-35) It is rare for the auditor to assess all identified risks of material misstatement for a material line item, account, note disclosure, or class of transactions at remote. If this is the case, the auditor should document justification for such assessment. See AU-C 315.A235 through .A246 for additional guidance on assessing inherent risk.

1. For each identified risk of material misstatement at the assertion level in each material line item, account, note disclosure, and class of transactions, the auditor should document the inherent risk factors considered in the assessment. For example, the auditor may assess inherent risk at high for an identified risk of material misstatement in the valuation of the net receivables line item due to (1) the materiality of the receivables and potential allowance, (2) the subjectivity of management’s judgment related to the loss allowance, and (3) management’s history of aggressively challenging any proposed adjustments to the valuation of the receivables. The auditor should also document other considerations regarding the likelihood and magnitude of the misstatement. See FAM 290 for detailed documentation requirements.

Respond to Inherent Risk

1. For each identified risk of material misstatement at the assertion level for which inherent risk is more than remote, in each material line item, account, note disclosure, and class of transactions, the auditor should
2. perform control tests of relevant control activities (i.e., those the auditor plans to test), to assess control risk and the risk of material misstatement (combined assessment of inherent risk and control risk) and
3. design and perform substantive procedures based on the assessment of risk of material misstatement.

Control tests are discussed in FAM 360. The assessment of control risk and risk of material misstatement is discussed in FAM 370. Substantive procedures are discussed in FAM 470.

1. In rare circumstances in which the auditor assessed all identified risks of material misstatement at remote for a material line item, account, note disclosure, or class of transactions, the auditor should nonetheless perform substantive procedures for that material line item, account, note disclosure, or class of transactions.[[35]](#footnote-36) Additionally, the auditor should perform control tests, as appropriate, if the auditor is providing an opinion on internal control.

Identify and Respond to Significant Risks

Identify Significant Risks

1. The auditor should determine whether any of the identified risks of material misstatement for which inherent risk is more than remote, including those related to accounting estimates, are **significant risks** (AU-C 315.36 and 540.16). A significant risk is an identified risk of material misstatement
2. for which the assessment of inherent risk is high (based on AU-C 315.12);[[36]](#footnote-37)
3. due to fraud, for which inherent risk is more than remote (AU-C 240.27); or
4. arising from transactions with disclosure entities, related parties, and public-private partnerships that are also significant unusual transactions, for which inherent risk is more than remote (AU-C 550.20).
5. Based on AU-C 315.A251, a significant risk may arise from matters such as

* transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved;
* accounting estimates that have high estimation uncertainty or complex models (for example, pension and post-retirement benefits liability estimates based on actuarial models) (see FAM 260.24);
* accounting for unusual or complex transactions (for example, accounting for revenue with multiple performance obligations that are difficult to value);
* emerging areas (for example, accounting for digital assets);
* complexity in data collection and processing to support account balances;
* account balances or quantitative disclosures that involve complex calculations;
* accounting principles that may be subject to differing interpretation; or
* changes in the entity’s operations that involve changes in accounting.

Respond to Significant Risks

1. If the auditor has determined that a significant risk exists, the auditor should identify the entity’s control activities that address such risk and evaluate their design and determine whether they have been implemented (AU-C 240.27, 315.27, and 315.30). As noted in FAM 265.25a, if these control activities are effectively designed and implemented, the auditor should test their operating effectiveness. See FAM 350 and 360 for guidance on performing control tests.
2. If the auditor has determined that an identified risk of material misstatement at the assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk (AU-C 330.22). In designing substantive procedures, the auditor should obtain more persuasive audit evidence the higher the auditor’s assessment of risk (AU-C 330.07b). When the approach to a significant risk consists only of substantive procedures (i.e., because controls are not effective), those procedures should include tests of details (AU-C 330.22). See FAM 470 for further guidance on performing substantive procedures.
3. As discussed in FAM 215, as part of communicating the planned scope and audit timing with those charged with governance, the auditor should communicate the significant risks that the auditor identified. For audits of group financial statements, see FAM 630 for requirements related to significant risks.
4. All fraud risks for which inherent risk is more than remote are significant risks. If a significant risk is related to fraud, the auditor should also perform the procedures in FAM 265.38 through .55.

Additional Procedures for Certain Risks

1. This section discusses additional risk assessment procedures the auditor should perform for the following risks:
2. risks related to accounting estimates;
3. risks related to disclosure entities, related parties, and public-private partnerships; and
4. fraud risks.

Risks Related to Accounting Estimates

1. As part of the auditor’s risk assessment procedures, the auditor should review the outcome of previous accounting estimates or, when applicable, their subsequent reestimation to assist in identifying and assessing the risks of material misstatement in the current period. The auditor should take into account the characteristics of the accounting estimates in determining the nature and extent of that review. The review is not intended to call into question judgments about previous-period accounting estimates that were appropriate based on the information available at the time they were made. (AU-C 540.13)
2. For accounting estimates, the auditor should determine whether the engagement team requires specialized skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement, to design and perform audit procedures to respond to those risks, or to evaluate the audit evidence obtained (AU-C 540.14).
3. In assessing inherent risk for identified risks of material misstatement relating to an accounting estimate and related note disclosures at the assertion level, the auditor should take the following into account (AU-C 540.15):
4. the degree to which the accounting estimate is subject to estimation uncertainty and
5. the degree to which one or both of the following are affected by complexity, subjectivity, or other inherent risk factors:
   * the selection and application of the method, assumptions, and data in making the accounting estimate and
   * the selection of management’s point estimate and related note disclosures for inclusion in the financial statements.

See FAM 340 and 905 for discussions on accounting estimates related to understanding control activities and performing substantive testing, respectively.

Risks Related to Disclosure Entities, Related Parties, and Public-Private Partnerships

1. For relationships and transactions with disclosure entities, related parties, and public-private partnerships, unless all of those charged with governance are involved in managing the entity, the auditor’s risk assessment procedures should include inquiring of those charged with governance regarding

* their understanding of the entity’s relationships and transactions with disclosure entities, related parties, and public-private partnerships that are significant to the entity and
* whether any of those charged with governance have concerns regarding these relationships or transactions and, if so, the substance of those concerns (AU-C 550.16).

Fraud Risks

1. The auditor should identify and assess the risks of material misstatement due to fraud (fraud risks)at the financial statement level and at the assertion level for line items, accounts, note disclosures, and classes of transactions (AU‑C 240.25). The primary factor that distinguishes fraud from error is that the action causing the misstatement in fraud is intentional. For fraud, the auditor’s risk assessment should be ongoing throughout the audit (AU-C 240.25). Accordingly, communications among the engagement team members about the risks of material misstatement due to fraud should continue throughout the audit, particularly upon discovery of new facts (AU-C 240.15). As the auditor obtains audit evidence during the audit, the auditor should consider its potential effect on the auditor’s assessment of fraud risks.
2. Two types of misstatements that are relevant to the auditor’s consideration of fraud in an audit of financial statements are as follows (Green Book 8.02):

* **Misstatements resulting from fraudulent financial reporting** are intentional misstatements, including omissions of amounts or disclosures in the financial statements, to deceive financial statement users. They could involve intentional alteration of accounting records, misrepresentation of transactions, intentional misapplication of accounting principles, or other means.
* **Misstatements resulting from misappropriation of assets** involve thefts of an entity’s assets that result in misstatements in the financial statements. They could involve theft of property, embezzlement of receipts, fraudulent payments, or other means. See FAM 310 for discussion of internal control over safeguarding assets. Safeguarding controls relate to protecting assets against loss from unauthorized acquisition, use, or disposition.

1. When identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transactions, or assertions give rise to such risks (AU-C 240.26). If the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud, the auditor should document the reasons for that conclusion (AU-C 240.46).
2. In considering misstatements resulting from misappropriation of assets, the auditor should consider fraud risks associated with improper payments. Some of the improper payments that entities make could involve fraud. The Payment Integrity Information Act of 2019 (PIIA) (Pub. L. No. 116-117), codified in 31 U.S.C. §§ 3351-58, defines an improper payment as any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. This includes any payment to an ineligible recipient, any payment for an ineligible good or service, any duplicate payment, any payment for a good or service not received (except for such payments where authorized by law), and any payment that does not account for credit for applicable discounts.

PIIA also provides that when an entity’s review is unable to discern whether a payment was proper as a result of insufficient or lack of documentation, this payment must also be considered an improper payment when identifying programs that might be susceptible to significant improper payments and when producing an estimate of annual improper payments for those identified programs.[[37]](#footnote-38)

PIIA requires entity heads to review all programs and activities that they administer at least once every 3 years and to identify those that might be susceptible to significant improper payments. An entity must produce a statistically valid (or otherwise OMB-approved) estimate of annual improper payments for those identified programs and report those estimates in the accompanying materials to the financial statements. For programs for which an entity reports an estimate of improper payments, the entity head also reports certain corrective actions, such as the entity’s plans to reduce and recover improper payments and program-specific improper payment reduction targets. OMB guidance on implementation of this act is included in OMB Circular No. A-123, Appendix C, and OMB Circular No. A-136.

1. The auditor is not required to perform specific procedures to detect waste or abuse, as the determination of waste and abuse is subjective. Waste is the act of using or expending resources carelessly, extravagantly, or to no purpose. Waste does not necessarily include abuse or illegal acts. Rather, waste relates primarily to mismanagement, inappropriate actions, and inadequate oversight. Abuse is distinct from fraud and illegal acts. Abuse involves behavior that is deficient or improper (but not necessarily fraudulent or illegal) when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate. Abuse does not necessarily involve fraud or violations of provisions of laws, regulations, contracts, or grant agreements.

Although the auditor is not required to perform procedures to detect waste or abuse, the auditor may consider whether and how to communicate such matters after becoming aware of them. The auditor may discover that the waste or abuse represents potential fraud or noncompliance with provisions of laws, regulations, contracts, and grant agreements that should be addressed following guidance in FAM 540. See GAGAS (2018) 6.20 through 6.24.

Consider Fraud Risk Factors

1. The auditor should consider fraud risk factors in identifying and assessing the risks of material misstatement due to fraud. Three conditions generally are present when fraud occurs:
2. **Incentive/pressure**—Management, other employees, or external parties (for example, for some improper payments) have an incentive or are under pressure, which provides a motive to commit fraud.
3. **Opportunity**—Circumstances exist, such as the absence of controls, ineffective controls, or the ability of management to override controls, that provide an opportunity to commit fraud.
4. **Attitude/rationalization**—Individuals involved are able to rationalize committing fraud. Some individuals possess an attitude, character, or ethical values that allow them to knowingly and intentionally commit a dishonest act. Generally, the greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud. (Green Book 8.04)
5. Although fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances in which fraud has occurred and therefore may indicate risks of material misstatement due to fraud (AU-C 240.24). While fraud risk may be greatest when all three conditions listed above are present, one or more of these conditions may indicate fraud risk. Other information that internal and external parties provide can also be used to identify fraud risks (Green Book 8.05). Examples of fraud risk factors, classified by the two types of fraudulent misstatements and then by these three conditions, are listed below. FAM 295 A and 295 B include additional examples of fraud risk factors.
6. Examples related to misstatements resulting from fraudulent financial reporting:
   * **Incentive/pressure**—Incentive exists for management to report reduced program costs or costs that are consistent with budgeted amounts, or excessive pressure exists to meet unrealistic deadlines, goals, or other requirements.
   * **Opportunity**—Key financial statement amounts are based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate, or management is in a position to override controls for processing adjustments or unusual transactions.
   * **Attitude/rationalization**—Employees perceive that penalties exist for reporting honest results, or employees consider requirements such as performance targets unrealistic.
7. Examples related to misstatements resulting from misappropriation of assets:
   * **Incentive/pressure**—Employees who are disgruntled because of impending layoffs have an incentive to misappropriate assets, or employees under pressure to meet programmatic objectives, such as for rapid benefit payments, increases the risk of fraudulent improper payments.
   * **Opportunity**—Employees have access to assets that are small in size and value or have the authority to disburse funds, or a program has deficiencies in internal control related to fraudulent improper payments.
   * **Attitude/rationalization**—Employees believe that management is unethical, or individuals believe they are entitled to the entity’s assets.

Obtain Information for Identifying Fraud Risks

1. To obtain information for use in identifying fraud risks, the auditor should inquire of management about (AU-C 240.17–.18)
2. any knowledge of actual, suspected, or alleged fraud affecting the entity (including fraudulent improper payments);
3. management’s assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent, and frequency of such assessments;
4. management’s process for identifying, responding to, and monitoring the risks of fraud in the entity, including
   * any specific risks of fraud that management has identified or that have been brought to its attention,
   * the line items, accounts, note disclosures, and classes of transactions for which a risk of fraud is likely to exist, and
   * any fraudulent improper payments that the entity identified in making assessments related to PIIA (Green Book 8.06);
5. management’s communication, if any, to employees regarding its views on business practices and ethical behavior;
6. management’s communication, if any, to those charged with governance, such as an audit committee (referred to as a financial management advisory committee in some entities) or others with equivalent authority and responsibility, regarding its processes for identifying and responding to the risks of fraud in the entity; and
7. whether the entity has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved disclosure entities, related parties, or public-private partnerships.

Inquiries of management and others within the entity are generally most effective when they involve a discussion. The auditor may also find it helpful to provide the interviewee with specific questions and obtain written responses in advance of the discussion.

1. In addition to inquiring of management, inquiring of others may provide a different perspective or other important information. Accordingly, the auditor should perform the following inquiries and related procedures:
2. Obtain information about instances of fraud (including any related to fraudulent improper payments) that the IG reported, ordinarily by asking the Special Investigator Unit to summarize how cases of reported fraud were committed, and then ask management or the IG’s office whether related controls have been strengthened.
3. Unless all of those charged with governance are involved in managing the entity, the auditor should do the following:
   * Obtain an understanding of how those charged with governance exercise oversight of management’s processes for identifying and responding to the risks of fraud in the entity and the controls that management has established to mitigate these risks (AU-C 240.20 and Green Book 8.06–8.07). This may include understanding whether those charged with governance have established a process for evaluating employees’ adherence to the organization’s standards of conduct and remediate any deviations timely and consistently (Green Book 1.10).
   * Inquire of those charged with governance to determine their views about the risks of fraud; whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity; and whether the entity has entered into any significant unusual transactions. These inquiries are made, in part, to corroborate the responses received from the inquiries of management (AU-C 240.21).
   * Inquire of those charged with governance to determine how they identify changes that could significantly impact the entity’s internal control system and whether they can identify, on a timely basis, internal and external conditions that have already occurred or are expected to occur (Green Book 9.02–9.03).
   * Inquire of those charged with governance to determine whether management performs an entity risk assessment to identify, analyze, and respond to any new risks prompted by changes as part of analyzing and responding to change. This may also include understanding how management analyzes and responds to identified changes and related risks in order to maintain an effective internal control system (Green Book 9.04 and 9.05).
4. Inquire of appropriate individuals within the internal audit function, if any, to obtain their views about the risks of fraud; determine whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity; whether they have performed any procedures to identify or detect fraud during the reporting period; whether management has satisfactorily responded to any findings resulting from these procedures; and whether they are aware that the entity has entered into any significant unusual transactions (AU-C 240.19). See FAM 645 if the auditor plans to use the work of the internal audit function in obtaining audit evidence.
5. Inquire of other personnel to determine if they have knowledge of any actual, suspected, or alleged fraud affecting the entity (AU-C 240.18). The auditor should use judgment to determine whom to ask and the extent of inquiries. For example, the auditor may inquire of employees with varying levels of authority, operating personnel not directly involved in the financial reporting process, employees familiar with complex or unusual transactions or with improper payments, and in-house legal counsel.

When responses to inquiries of management, those charged with governance, or others are inconsistent or otherwise unsatisfactory (for example, vague or implausible), the auditor should further investigate the inconsistencies or unsatisfactory responses (AU-C 240.14).

1. The auditor also should perform the following procedures:
2. Obtain and review the entity’s (1) plan to identify improper payments and (2) report on improper payments (or information about any findings), if any, that resulted from the entity’s review under PIIA.
3. Evaluate whether preliminary analytical procedures identified any unusual or unexpected relationships that indicate fraud risks. To the extent that they are not already included, the analytical procedures, and evaluation thereof, should include procedures relating to revenue accounts—for example, trend analysis—to identify unusual or unexpected relationships that might indicate fraudulent financial reporting of revenue (see FAM 225 related to preliminary analytical procedures) (AU-C 240.22).
4. Consider whether other information—such as information that resulted from previous audits; the brainstorming meeting(s); and inherent risks identified at the account, transaction, or assertion levels—indicate fraud risks (AU‑C 240.23 and 940.17).

Respond to Fraud Risks

1. The auditor should respond to the risks of material misstatement due to fraud at the financial statement and assertion levels. The nature and significance of these fraud risks, as well as programs and controls that address fraud risks, influence the auditor’s response. The auditor should use professional judgment in determining the appropriate response for the circumstances and exercise professional skepticism in gathering and evaluating audit evidence.
2. If it is not practicable, as part of a financial statement audit, to design audit procedures that sufficiently respond to the fraud risks, the auditor may request assistance from the Special Investigator Unit and evaluate the effect of omitting these procedures on the scope of the audit and the audit report.
3. In some instances, the audit strategy and audit plan could, for reasons other than responding to fraud risk, include procedures and personnel and supervisory assignments that are sufficient for responding to a fraud risk. In those instances, the auditor may conclude that no further response is required. For example, with respect to timing, audit procedures could be planned as of the date that the reporting period ends, both as a response to a fraud risk and for other reasons.
4. The auditor should determine the overall responses to address the risks of material misstatement due to fraud **at the financial statement level** (AU-C 240.28). In doing so, the auditor should perform the following procedures:
5. Assign and supervise staff, taking into account the knowledge, skill, and ability of personnel to be given significant engagement responsibilities and the auditor’s assessment of the risks of material misstatement due to fraud for the engagement (AU-C 240.29a). For example, the auditor may assign a fraud specialist or more experienced staff member or may increase supervision in response to identified fraud risks (also see FAM 270 related to IS controls auditors).
6. Evaluate whether the entity’s selection and application of accounting policies, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management’s effort to manage earnings or a bias that may create a material misstatement (AU-C 240.29b).
7. Incorporate an element of unpredictability in the selection of the nature, timing, and extent of audit procedures (AU-C 240.29c). For example, perform substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk, adjust the timing of audit tests, use a different method to select items for testing, or perform procedures at different locations or at locations on an unannounced basis (AU-C 240.A42). Statistical sampling selection usually provides an element of unpredictability as to the specific items tested (see FAM 480). Generally, the auditor should not inform entity personnel of specific audit procedures prior to performing them, as personnel may take actions to further conceal any fraudulent activity. However, the auditor will usually make arrangements to conduct audit work at specific sites in advance, and will instruct entity personnel to locate certain documentation so that the auditor may test it upon arrival.
8. Based on AU-C 240.30, the auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the risks of material misstatement due to fraud **at the assertion level** for which inherent risk is more than remote. Further audit procedures should involve both control and substantive tests. The auditor’s response may include changing the nature, timing, and extent of further audit procedures (AU-C 240.A43), such as
9. obtaining evidence from independent external sources rather than internal sources (nature),
10. increasing sample sizes (extent), or
11. performing substantive procedures at or near the end of the reporting period rather than at an interim date (timing).

FAM 295 I provides additional examples of responses to fraud risks.

1. Management is in a unique position to perpetrate fraud because of management’s ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is, nevertheless, present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and is thus a significant risk (AU-C 240.31).
2. Even if the auditor did not identify specific risks of material misstatement due to fraud, a possibility exists that management override of controls could occur. Accordingly, the auditor should address the risk of **management override of controls** apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing the following procedures (AU‑C 240.32):
3. **Examination of journal entries and other adjustments**—Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including entries posted directly to financial statement drafts. These include reclassifications, consolidating entries, and other journal entries and adjustments. In designing and performing audit procedures for such tests, the auditor should
   * obtain an understanding of the entity’s financial reporting process and controls over journal entries and other adjustments, and evaluate the design and determine whether the controls have been implemented;
   * inquire of individuals involved in the financial reporting process about inappropriate or unusual activity related to the processing of journal entries and other adjustments;
   * consider fraud risk indicators, the nature and complexity of accounts, and unusual entries processed;
   * select journal entries and other adjustments made at the end of the reporting period for testing; and
   * consider the need to test journal entries and other adjustments throughout the period.

See AU-C 240.A47 through .A50 and .A56 for additional guidance.

1. **Review of accounting estimates**—Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In preparing financial statements, management is responsible for making judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of these estimates on an ongoing basis.

In performing this review, the auditor should evaluate whether the judgments and decisions made by management in making accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity’s management that may represent a risk of material misstatement due to fraud. If so, the auditor should reevaluate the accounting estimates taken as a whole.

The auditor also should perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the prior year’s financial statements. Estimates selected for review should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management. For example, significant changes in allowances for uncollectible accounts that may be tied to performance measures in an effort to improve collections.

1. **Evaluation of business purpose for significant unusual transactions**—Evaluate, given the auditor’s understanding of the entity and its environment and other information obtained during the audit, whether the business purpose (or the lack thereof) of significant unusual transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. The procedures should include the following:

* reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
* determining whether the transaction has been authorized and approved in accordance with the entity’s established policies and procedures; and
* evaluating whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements.

Fraud risk indicators include the following (AU-C 240.A54):

* the form of these transactions appears overly complex (for example, the transactions involve multiple entities within a consolidated group or multiple unrelated third parties);
* management has not discussed the nature of and accounting for these transactions with those charged with governance, and inadequate documentation exists;
* management is placing more emphasis on the need for a particular accounting treatment than on the economic substance of the transaction;
* transactions involve disclosure entities, related parties, or public-private partnerships, including special purpose entities, have not been properly reviewed or approved by those charged with governance;
* transactions involve disclosure entities, related parties, or public-private partnerships or relationships or transactions with such entities previously undisclosed to the auditor (see FAM 904);
* transactions involve other parties that do not have the substance or financial strength to support the transactions without assistance from the entity or any disclosure entity, related party, or public-private partnership of the entity; and
* transactions occur with a party that falls outside the definitions of a related party, disclosure entity, or public-private partnership (as defined by the applicable financial reporting framework (generally U.S. GAAP)), with either party able to negotiate terms that may not be available for other, more clearly independent parties on an arm’s–length basis.

The auditor should determine whether other audit procedures, in addition to those discussed above, are needed to address the risks of management override of controls (AU-C 240.33).

1. If the auditor identifies deficiencies in controls designed to prevent, or detect and correct, misstatements caused by fraud, the auditor should take into account those deficiencies when developing the response to risks of material misstatement (AU-C 940.17).

Evaluate Audit Evidence Obtained

1. The auditor should evaluate whether the audit evidence obtained from the risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement. If not, the auditor should perform additional risk assessment procedures until audit evidence has been obtained to provide an appropriate basis. In identifying and assessing the risks of material misstatement, the auditor should take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management (AU-C 315.39).
2. If the auditor obtains new information that is inconsistent with the audit evidence on which the auditor originally based the identification or assessments of the risks of material misstatement, the auditor should revise the identification or assessment (AU-C 315.41). See FAM 530 for guidance on reassessing the risks of material misstatement.

270 – Determine Likelihood of Effective IS Controls

1. As discussed in FAM 265, information systems often involve **information system processing**, which is performed through the use of information technology. When relevant control activities,[[38]](#footnote-39) discussed in FAM 350, depend on information system processing, the auditor should assess IS controls. A dependency on information system processing exists if a control activity cannot reasonably be expected to achieve a specific control objective without effective information system processing, either in the performance of the control activity or in the production of information used in the performance of the control activity.
2. IS controls consist of those internal controls that depend on information system processing and include general controls, application controls, and user controls. Information system general controls (implemented at the entity-wide, system, and application levels) are the structure, policies, and procedures that apply to all or a large segment of an entity’s information systems.
3. **General controls** help ensure the proper operation of information systems by creating the environment for effective operation of application controls. General controls include security management, access (logical and physical), configuration management, segregation of duties, and contingency planning controls. An effective information system general control environment
   * provides a framework and continuing cycle of activity for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of the entity’s computer-related controls (security management);
   * limits or detects access to computer resources, such as data, programs, equipment, and facilities, thereby protecting them against unauthorized modification, loss, or disclosure (logical and physical access);
   * prevents unauthorized changes to information system resources, such as software programs and hardware configurations, and provides reasonable assurance that systems are configured and operating securely and as intended (configuration management);
   * includes policies, procedures, and an organizational structure to manage who can control key aspects of computer-related operations (segregation of duties); and
   * protects critical and sensitive data, and provides for critical operations to continue without disruption or be promptly resumed when unexpected events occur (contingency planning).
4. **Application controls**, sometimes referred to as business process controls, are those controls incorporated directly into information systems to help ensure the validity, completeness, accuracy, and confidentiality of transactions and data during information system processing. An effective application control environment includes

* general controls implemented at the application level (i.e., security management, access controls, configuration management, segregation of duties, and contingency planning);
* controls over transaction data input, processing, and output as well as master data maintenance;
* interface controls over the timely, accurate, and complete processing of information between information systems; and
* controls over the data management systems.

1. **User controls** are portions of controls that people perform when interacting with information systems. The effectiveness of a user control typically depends on information system processing or the reliability of the information that information systems produce. A user control is considered both an IS control and a manual control if it depends on information system processing. For example, the effectiveness of a user control to review and follow up on exceptions typically depends on the reliability of the exception report that the information system produces through information system processing. A user control is considered a manual control if it does not depend on information system processing. For example, the effectiveness of a user control to manually reconcile information that information systems produce may or may not depend on the reliability of information used in the reconciliation, depending on the nature of the control. Additionally, the effectiveness of a user control to monitor the effective functioning of information systems and IS controls may or may not depend on the reliability of information that the information systems produce.
2. In the planning phase, the auditor should identify and document the relevant control activities that depend on information system processing. Such control activities are often application and user controls. The auditor should then identify and document the general controls implemented at the entity-wide, system, and application levels that help ensure the effective operation of the application and user controls. Because of the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in planning, directing, or performing audit procedures related to assessing IS controls. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls.[[39]](#footnote-40)
3. The auditor should understand the design of the general controls identified to the extent necessary to conclude tentatively whether these controls are likely to be effective. The procedures performed to determine the likelihood of effective IS controls build on those procedures performed to (1) gain an understanding of the entity’s operations, including the design of its internal controls, and (2) assess the effects of information technology and information system processing on inherent risk and internal control.
4. If the general controls identified are likely to be effective, the auditor should consider other specific IS controls in determining whether control objectives are achieved in the internal control phase. As discussed in AU-C 315.A201, evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. See FAM 350.
5. If the general controls identified are not likely to be effective, the auditor should obtain a sufficient understanding of information system processing to

* identify types of potential misstatements,
* consider factors that affect the risks of material misstatement,
* design tests of controls and substantive procedures, and
* develop appropriate findings.

1. Also, in the internal control phase, the auditor generally should understand the design effectiveness of manual controls in achieving control objectives, including manual reviews or reconciliations, that may mitigate deficiencies in IS controls. If IS controls are not likely to be effective because of poor general controls **and** if manual controls do not achieve the control objectives, the auditor should understand the design of any application-level IS controls that are intended to achieve the control objectives to develop recommendations for improving internal controls.
2. The auditor should use an appropriate methodology when identifying and assessing IS controls and should document the basis for believing that the methodology used is appropriate to satisfy these requirements. If the auditor uses the same methodology for multiple audits, the audit organization may prepare this document once and maintain a central file for reference on individual audits.

GAO auditors should use the *Federal Information System Controls Audit Manual* (FISCAM) when assessing IS controls in a financial statement audit. FISCAM is designed to meet these requirements, and GAO believes that FISCAM is an appropriate methodology. See FAM 295 J for a flowchart of steps generally followed in assessing IS controls in a financial statement audit.

1. Information system security controls are also addressed in

* OMB Circular No. A-130, *Managing Information as a Strategic Resource*;
* NIST’s *An Introduction to Information Security*; and
* National Security Agency guidance on Microsoft and other computer vendor websites and various publications.

OMB’s guidance on reporting under FISMA specifies NIST publications that agencies are to use when evaluating information security (see FISMA section in FAM 260). The auditor may coordinate the work performed to meet the provisions of FISMA (44 U.S.C. §§ 3551-3558) with work performed as part of the financial statement audit.

275 – Identify Relevant Operations Controls to Evaluate and Test

1. In a financial statement audit, the auditor draws a conclusion about the effectiveness of financial reporting (including safeguarding and budget) and compliance (including budget) controls. For operations controls, the auditor

* may evaluate certain operations controls considered relevant (see FAM 275.02 through .07) and
* should evaluate and test operations controls that are relied on in performing audit procedures (see FAM 275.08).

Relevant Operations Controls

1. Relevant operations controls are based on the needs of the auditor. The auditor should determine whether the evaluation of relevant operations controls will (1) be included in the financial audit, (2) become a separate audit, or (3) not be performed though any deficiencies noted will be reported to entity management and the IG. In making this determination, the auditor may consider the following factors:

* the significance of the operations controls to the entity’s operations,
* the time required to identify and test the operations controls,
* available resources,
* the needs of those charged with governance, and
* congressional interest.

1. The auditor should document the operations controls identified for testing, the procedures performed, and the results.
2. In the planning phase and throughout the audit, the auditor may identify significant areas where the entity would be expected to have operations controls. The auditor may become aware of these areas, as well as potential deficiencies in operations controls, through

* prior audit work;
* documenting an understanding of entity operations;
* assessing the risks of material misstatement and deficiencies in financial reporting and compliance controls;
* other audit planning procedures, including any reviews of the FMFIA documentation that the entity prepared;
* understanding the cause of misstatements noted; or
* observing activities during fieldwork.

1. In obtaining an understanding of the entity’s operations, the auditor typically would have identified areas that are critical to the operations. For each of these areas, the entity should have effective operations controls. Also, in planning the audit, the auditor may identify operations controls that could be evaluated in conjunction with planned audit and other procedures. For example, in a test of inventory purchases the auditor may evaluate whether management considered appropriate order quantities for each inventory purchase selected to avoid a buildup of excess inventory.
2. The auditor may identify risks of material misstatement and control deficiencies in planning and performing the audit and in determining the causes of misstatements requiring audit adjustments. The auditor should evaluate the implications of those risks and deficiencies on the entity’s operations controls if

* the effectiveness of a financial reporting or compliance control depends on the effectiveness of the operations control;
* the auditor plans to rely on this control during the audit; or
* the auditor is required to test the control following OMB audit guidance.

For example, misstatements in inventory records may indicate deficiencies in operations controls whose effectiveness depends on accurate inventory records. This would include the operations controls for maintaining proper inventory levels, including those for detecting theft or loss.

1. The auditor may find opportunities to recommend improvements to operations controls and may choose to test the effectiveness of other operations controls. Such opportunities could come to light while visiting the entity’s various locations and performing audit procedures.

Operations Controls Relied on in the Audit

1. If any contemplated audit procedure relies on operations controls, the auditor should identify and test such controls. For example, assume that an auditor is using substantive analytical procedures, based on entity-generated “per unit” statistics, to test the reasonableness of certain operating costs. The auditor plans to compare such per unit statistics with published costs incurred by similar operations. The auditor should identify and test the entity’s operations controls and other types of controls, as appropriate, over the production of these internal statistics.

As discussed in FAM 495 A.20 through .22, if the reliability of internally generated data used in substantive tests, such as substantive analytical procedures, depends on the effectiveness of IS controls, the auditor should perform additional procedures before relying on the data. The auditor should test, as appropriate, the relevant general controls and the specific application level controls over the data, the data in the report, or both.

280 – Plan Other Audit Procedures

1. The auditor generally should plan for performing procedures in the following areas during other phases of the audit.

The auditor should also consider the implementation guidance in volume 2 of the FAM as applicable. Volume 2 includes areas such as using the work of others, determining compliance with FFMIA and other laws, performing agreed-upon procedures, and substantive testing.

Litigation, Claims, and Assessments

1. The auditor should make inquiries of the entity’s legal counsel and perform other audit procedures regarding litigation, claims, and assessments. This is necessary to assess potential liabilities and contingencies. Entity management and legal counsel may need significant time to gather and report necessary information, including the potential need for inquiries of Department of Justice legal counsel on a case-specific basis. Additionally, for initial audits and changes in personnel, the auditor may discuss with management why a response from the entity’s legal counsel is needed as part of a financial statement audit. See FAM 1002 for additional guidance.
2. Based on AU-C 501.17 and .A43, the auditor should design and perform audit procedures to identify litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement, including

* inquiring of management and, when applicable, others within the entity, including in-house legal counsel, which may include discussing their policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments;
* obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the date of the financial statements being reported on and during the period from the date of the financial statements to the date the information is furnished, including identification of those matters referred to legal counsel;
* reviewing minutes of meetings of those charged with governance; documents obtained from management concerning litigation, claims, and assessments; and correspondence between the entity and its legal counsel; and
* reviewing legal expense accounts and invoices from external legal counsel.

1. Based on AU-C 501.19 and .20, the auditor should seek direct communication with the entity’s in-house legal counsel regarding the entity’s litigation, claims, and assessments.[[40]](#footnote-41) The auditor should do so through a legal counsel request prepared by management and sent by the auditor requesting that the entity’s in-house legal counsel communicate directly with the auditor.

In addition to the direct communication with the entity’s in-house legal counsel, the auditor should, when the entity’s external legal counsel is responsible for the entity’s litigation, claims, and assessments, seek direct communication with the entity’s external legal counsel through a legal counsel request similar to the request made to the in-house legal counsel.[[41]](#footnote-42)

The legal counsel response(s) may be limited to matters that are considered individually or collectively material to the financial statements, such as when the entity and the auditor have reached an understanding on the limits of materiality for this purpose and management has communicated such understanding to the legal counsel (AU-C 501.A57). See FAM 1002 B for an example legal counsel request and FAM 1002 C for an example legal counsel response.

1. During planning, the auditor also should apply any additional requirements in OMB audit guidance related to legal counsel requests and responses. For example, OMB audit guidance indicates that the interim and updated responses from legal counsel for specified entities are to be submitted to specified parties by specific dates that the Department of the Treasury establishes.

Management Representations

1. As discussed in FAM 550, the auditor should obtain a representation letter from entity management, and when appropriate, those charged with governance, on specific matters at the completion of the audit. Particularly for first-year audits, when standards change, and when management changes, the auditor may find it useful to discuss representations with management early in the audit to identify and resolve any difficulties related to obtaining these representations at the end of the audit. These representations include
   * + - * the effectiveness of internal control over financial reporting;
         * compliance with laws, regulations, contracts, and grant agreements;
         * management’s materiality thresholds for reporting; and
         * for CFO Act agencies, whether financial management systems comply substantially with FFMIA requirements.

Additionally, the auditor should prepare a summary of uncorrected misstatements (including prior period misstatements that affect the current financial statements) and attach it to the representation letter. FAM 595 C provides an example of a summary of uncorrected misstatements. The representation letter should state management’s belief that the effects of the misstatements are immaterial to the financial statements as a whole, both individually and in the aggregate.

During planning, the auditor should also apply any additional requirements in OMB audit guidance related to management representations. For example, OMB audit guidance indicates that the auditor should provide and discuss with management a draft representation letter as early as possible in the audit and update the letter for circumstances found throughout the audit. Additional guidance on management representations is provided in AU-C 580, AU-C 940, AT-C 205, AT-C 215, AT-C 315, and FAM 1001.

Relationships and Transactions with Disclosure Entities, Related Parties, and Public-Private Partnerships

1. Throughout the planning phase, the auditor should perform procedures to (1) obtain an understanding of the entity’s relationships and transactions with disclosure entities, related parties, and public-private partnerships (see FAM 220); (2) consider the susceptibility of the financial statements to material misstatement due to fraud or error that could result from such relationships and transactions (see FAM 265); and (3) identify the risks of material misstatement (see FAM 265).[[42]](#footnote-43) The identity of the entity’s disclosure entities, related parties, and public-private partnerships and other relevant information should be distributed to all members of the engagement team (AU-C 550.19).

Throughout the audit, engagement team members should remain alert when inspecting records or documents for arrangements or other information that may indicate the existence of additional relationships or transactions with disclosure entities, related parties, and public-private partnerships that management has not previously identified or disclosed to the auditor (AU‑C 550.17). Also see FAM 904 for additional procedures the auditor should perform and FAM 550 for concluding on relationships and transactions with disclosure entities, related parties, and public-private partnerships.

The auditor generally should (1) inquire about the population of entities that management considered when evaluating the existence of a disclosure entity and the method used to assess whether an entity meets the requirements for disclosure and (2) for any disclosure entities identified by management, inquire of the methods for determining the information that should be disclosed in the financial statements, which is based on both qualitative and quantitative materiality and the following factors (SFFAS 47):

* relevance to reporting objectives;
* nature and magnitude of the potential risks/exposures or benefits associated with the relationship;
* complexity of the relationship;
* extent to which the information interests, or may be expected to interest, a wide audience; and
* extent to which there are no alternative sources of reliable information.

Required Supplementary Information

1. Per U.S. GAAP, certain information is to be included with the entity’s financial statements and to be labeled as RSI. Although this information is not a part of the financial statements, FASAB considers this information to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context (AU-C 730.04). Some examples of RSI include the MD&A, information regarding social insurance per SFFAS 17, and information regarding the Statement of Custodial Activity per SFFAS 7.

For RSI, the auditor should perform the following (AU-C 730.05):

1. Inquire of management about the methods of preparing the information, including
   * whether it has been measured and presented in accordance with the prescribed guidelines,
   * whether methods of measurement or presentation have been changed from those used in the prior period and the reasons for any such changes, and
   * whether there were any significant assumptions or interpretations underlying the measurement or presentation of the information.
2. Compare the information for consistency with (also see FAM 520 for applying analytical procedures)
   * management’s responses to the auditor’s inquiries,
   * the financial statements, and
   * other knowledge obtained during the audit of the basic financial statements.
3. Obtain written representations from management
   * that it acknowledges its responsibility for RSI;
   * about whether RSI is measured and presented in accordance with prescribed guidelines;
   * about whether the methods of measurement or presentation have changed from those used in the prior period and, if so, the reasons for such changes; and
   * about any significant assumptions or interpretations underlying the measurement or presentation of RSI—refer to FAM 1001 A for management representation letter example.

OMB also provides reporting guidance on RSI. See FAM 550.23 through .24 for information on concluding on RSI and FAM 580.38 regarding how the auditor reports on the work performed in this area.

Other Information Included with the Financial Statements

1. Per U.S. GAAP and OMB reporting guidance, certain information is to be included with the entity’s financial statements and to be labeled as other information. Other information is financial or nonfinancial information (other than the basic financial statements, RSI, and auditor’s report) included in an entity’s annual report (AU-C 720.12).

For other information, the auditor should perform the following:

1. Through discussion with management, determine and obtain management’s written acknowledgment regarding which document(s) comprise the annual report and the entity’s planned manner and timing of the issuance of such document(s) (AU-C 720.13a).
2. Make appropriate arrangements with management to obtain in a timely manner and, if possible, prior to the date of the auditor’s report, the final version of the document(s) comprising the annual report (AU-C 720.13b).
3. When some or all of the documents determined to be part of the annual report will not be available until after the date of the auditor’s report on the financial statements, request management to provide a written representation that the final version of the documents will be provided to the auditor when available, and prior to the documents’ issuance by the entity, such that the auditor can complete the required procedures (AU-C 720.13c).
4. If the auditor becomes aware that the entity did not provide the auditor with the final version of documents determined to be part of the annual report prior to the issuance of those documents to third parties, the auditor should take appropriate action (AU-C 720.14), which may include

* obtaining those documents from management and performing the required procedures, as discussed below, as soon as practical;
* communicating the matter to those charged with governance, if applicable; and
* considering the need to obtain legal advice (AU-C 720.A25).

1. Communicate with those charged with governance the auditor’s responsibility with respect to the other information, any procedures performed relating to the other information, and the results (AU-C 720.15).
2. Read the other information and consider whether a material inconsistency exists between the other information and the financial statements. As the basis for this consideration, to evaluate their consistency, the auditor should compare selected amounts or other items in the other information (that are intended to be the same as, to summarize, or to provide greater detail about the amounts or other items in the financial statements) with such amounts or other items in the financial statements. While reading the other information, the auditor should remain alert for indications that (1) a material inconsistency exists between the other information and the auditor’s knowledge obtained in the audit and (2) a material misstatement of fact exists or the other information is otherwise misleading. The auditor is not responsible for searching for omitted information for the completeness of the other information. (AU-C 720.16–.18)

See FAM 550.25 through .29 for information on concluding on other information and FAM 580.39 regarding how the auditor reports on the work performed in this area.

Supplementary Information

1. If the auditor is engaged to report on whether supplementary information, such as consolidating statements, is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should follow the requirements in AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*.

Opening Balances

1. AU-C 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*, provides guidance on the audit procedures the auditor should perform related to opening balances in an engagement in which the financial statements for the prior period were not audited or were audited by a predecessor auditor (initial audit engagement). This includes engagements to audit financial statements that have been previously audited by a predecessor auditor (reaudit engagement).

During the planning phase, the auditor should request that entity management authorize the predecessor auditor, if any, to allow a review of its audit documentation and respond fully to inquiries by the auditor. The auditor uses this information to assist in planning and performing the audit. The auditor should plan audit procedures to obtain sufficient appropriate audit evidence about whether

* + - * 1. opening balances, including note disclosures that existed at the beginning of the period, contain misstatements that materially affect the current year’s financial statements and
        2. appropriate accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements or changes thereto are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework (generally U.S. GAAP).

See AU-C 510 for the specific requirements to be satisfied related to performing, concluding on, and reporting on opening balances for initial audit engagements and reaudit engagements.

Other Planning Issues

1. Auditors should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements or other financial data significant to the audit objectives. When planning the audit, auditors should ask entity management to identify previous audits, attestation engagements, and other studies that directly relate to the objectives of the audit, including whether related recommendations have been implemented. Auditors should use this information in assessing risk of material misstatement and determining the nature, timing, and extent of further audit procedures, including determining the extent to which testing the implementation of the corrective actions is applicable to the current audit objectives.
2. The auditor should determine whether any findings and recommendations from the prior-year financial audit need follow-up that would not otherwise be evaluated in the current-year procedures, such as findings at locations that would not otherwise be tested. The auditor should determine whether to test the implementation of the recommendation or to repeat the finding.

Additional Audit Guidance

1. During planning, the auditor also should apply additional requirements in OMB audit guidance. For example, OMB audit guidance indicates that certain agreed-upon procedures are to be applied to entity payroll offices and the related reports are to be submitted to the Office of Personnel Management by a specific date. FAM 710 provides guidance on agreed-upon procedures reporting.

285 – Plan Locations to Test

1. Most entities conduct operations, perform accounting functions, and retain records at multiple locations. During planning, the auditor should evaluate the effect of these multiple locations on the audit approach and generally should consult with an audit sampling specialist when testing involves the selection of locations. The auditor should develop an understanding of the respective locations, including the material classes of transactions processed and significant financial management systems used at those locations. This understanding may be obtained virtually, in person, or both and either centrally or in combination from multiple field locations, as appropriate. When planning locations to test, the auditor should evaluate whether certain locations warrant more extensive testing than others, based on the following factors:
2. Materiality or significance of locations to the overall entity. More material locations, particularly those individually generating transactions or account balances that exceed performance materiality or those with significant information system processing may indicate the need for more extensive testing.
3. The results, if location specific, of the preliminary analytical procedures applied during planning. The auditor should follow up on unusual results, possibly including testing specific locations with unusual results.
4. The results and the extent of audit procedures applied in prior years by the auditor or others, including the time since significant procedures were performed. Problems noted in prior audits, if not corrected, could indicate areas of concern for the current audit; the applicability of prior evidence ordinarily diminishes with the passage of time.
5. The auditor’s understanding of internal control components, and preliminary assessment of overall inherent risk, at each location, including the nature of operations, sensitivity to economic conditions, and key management turnover. Locations at which internal control components are weak or inherent risk is high generally warrant more extensive testing than those where internal control components are strong or inherent risk is low. In addition, the inherent risk may be different for different accounts and assertions at each location.
6. The auditor’s assessment of the risk of material misstatement due to fraud. Locations at which the auditor has assessed a higher risk of material misstatement due to fraud warrant more extensive testing than those where the auditor has assessed a lower risk of material misstatement due to fraud.
7. The auditor’s assessment of the risk of material misstatement. Locations at which risk of material misstatement is high warrant more extensive testing than locations where risk of material misstatement is low.
8. The extent to which accounting records are centralized. A high degree of centralization may enable the auditor to conduct the majority of work on the central location, with only limited work on other locations.
9. The extent of uniformity of control systems (including IS controls) throughout the entity. The number of locations tested is a function of the uniformity of significant control systems. For example, if there are two major procurement control systems, the auditor generally should test each system to a sufficient extent. Where locations develop or modify systems, the auditor may test more locations than for those entities using centrally developed systems that cannot be changed locally.
10. The extent of work performed by other auditors. The auditor may use work performed by other auditors to reduce or eliminate testing selected locations or to assist in testing locations not selected. (See FAM 620, 630, 640, and 645.)
11. Special reporting or entity requirements. The auditor should test sufficient locations to meet special needs, such as the need for separate-location reports.
12. The auditor should plan the general nature of audit procedures to be performed for each location. The extent of testing may vary between locations, depending on tolerable misstatement, risk of material misstatement, and other factors. Using common audit plans, audit documentation formats, and indexes for the various locations tested makes it easier to plan, review the audit documentation, and combine the results of all locations to improve effectiveness and efficiency. The auditor should vary the nature, timing, and extent of testing controls at locations or business units from year to year.
13. The auditor should obtain an understanding of the design of the procedures for combining the locations’ financial information to prepare the entity’s financial statements. The auditor should understand and test these procedures during the audit, including controls for adjustments, reclassifications, and eliminations.
14. One approach to stratifying locations, selecting locations to test, and selecting individual audit samples for multiple-location audits is presented in FAM 295 C. This method assumes that increased testing is not required for any location because of the factors in FAM 285.01. If the auditor uses other methods to select locations for testing, the basis for doing so must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved. For example, selecting fewer locations but more items to test for each location may be appropriate in some instances. Although other methods generally involve more testing than the method described in FAM 295 C, the efficiencies of performing additional work on fewer locations may be higher.
15. The auditor should document the planned locations to test in the audit strategy, audit plans, or equivalent documents.

290 – Documentation

1. Based on AU-C 230.08, the auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand

* the nature, timing, and extent of the audit procedures performed to comply with GAGAS, including the AICPA Statements on Auditing Standards and applicable attestation standards, and applicable legal and regulatory requirements;
* the results of the audit procedures performed and the audit evidence obtained; and
* significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

AU-C 230.A4 describes factors that the auditor should consider in determining the form, content, and extent of audit documentation.

1. In the FAM, each phase of the audit contains a separate section that describes audit documentation requirements. The auditor should document relevant information as described in this section and update these documents to respond to any changes in circumstances during the course of the audit. The auditor should document any significant changes made during the audit engagement to the overall audit strategy or the audit plan and the reasons for such changes (AU-C 300.14c). Information that is likely to be useful in future audits may be documented in a permanent file.
2. The auditor should document the understanding of the **terms of the engagement** established with the client,including the understandings reached with management and those charged with governance as described in FAM 215. This documentation may consist of copies of engagement letters, contracts, and other written agreements and should document management’s agreement with its responsibilities in a financial statement audit.
3. In the **entity profile** or an equivalent document, the auditor should document the information useful for understanding the entity and its operations (FAM 220). Based on AU-C 315.19 and .42b, the auditor should document key elements of the auditor’s understanding, including those discussed in FAM 220.01, and the sources of information from which the auditor’s understanding was obtained.

The auditor generally should limit the information in the entity profile to that which is relevant to planning the audit. This information may include documents prepared by the entity, such as historical information or the mission of the entity. If these and other documents were prepared in prior years, the auditor should update them for any changes each year.

1. The auditor should document the results of **brainstorming discussions** about the susceptibility of the entity’s financial statements to material misstatement due to error or fraud (FAM 265). The auditor should document these discussions, including how and when the discussion occurred, the subject matter discussed, the engagement team members who participated, and significant decisions reached (AU‑C 240.43a and 315.42a).
2. In establishing the overall **audit strategy** that sets the scope, timing, and direction of the audit and that guides the development of the audit plan, as discussed in AU-C 300.07 through .08, the auditor should
   1. identify the characteristics of the engagement that define its scope;
   2. ascertain the reporting objectives of the engagement in order to plan the timing of the audit and the nature of the communications required;
   3. consider the factors that in the auditor’s professional judgment, are significant in directing the engagement team’s efforts;
   4. consider the results of preliminary engagement activities and, when applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
   5. ascertain the nature, timing, and extent of resources necessary to perform the engagement.
3. The audit strategy should include or refer to information on the following areas:
4. **Conclusions reached regarding acceptance and continuance of the client relationship and audit engagement, including inquiries of the predecessor auditor and the results thereof, if applicable (FAM 215).**
5. **Parties identified as those charged with governance (FAM 215).**
6. **Compliance with relevant ethical requirements (FAM 215).** This information includes
   * any issues identified and how they were resolved,
   * any threats to independence and the safeguards applied, and
   * conclusions on compliance with independence requirements that apply to the audit engagement and any relevant discussions with the audit organization that support the conclusion.
7. **Accounting and auditing standards (FAM 215).**
   * Accounting standards, including whether the financial reporting framework to be applied in the preparation of the financial statements (generally U.S. GAAP) is acceptable.
   * Auditing standards and guidance applicable to the engagement (e.g., GAGAS), including any
   * interpretive publications, which consist of, among other things, auditing interpretations of U.S. GAAS, auditing guidance included in AICPA Audit and Accounting Guides, and AICPA Auditing Statements of Position (AU-C 200.14 and .27), and
   * other auditing publications (AU-C 200.28).
8. **Results of the prior year’s audit.**
9. **Preliminary analytical procedures and the results of those procedures (FAM 225).** The auditor should document the following information:
   * Data used and the sources of these data for current-year amounts and for developing expected amounts, including
   * the amounts of the financial items;
   * the dates or periods covered by the data;
   * whether the data are audited or unaudited;
   * the person from whom the data were obtained (if applicable); and
   * the source of the information, such as general ledger trial balances, prior-year audit documentation, or prior-year financial statements.
   * Parameters for identifying significant fluctuations from expectations.
   * Explanations for fluctuations from expectations identified and sources of those explanations, including the name(s) and title(s) of the person(s) from whom the explanations were obtained.
   * The auditor’s conclusion and consideration of the impact of the results of preliminary analytical procedures on the audit strategy.
10. **Amount and basis for materiality determination and any revisions to materiality as the audit progresses (FAM 230).** This should include

* materiality for the financial statements as a whole,
* performance materiality,
* tolerable misstatement,
* clearly trivial,
* materiality levels for FMFIA, management representation letter, and legal counsel response, and
* if applicable, materiality levels for particular line items, accounts, note disclosures, or classes of transactions (AU-C 320.14).

1. **Significant provisions of applicable laws and regulations (FAM 245).**
2. **Approach for identifying and testing significant provisions of contracts and grant agreements (FAM 245).**
3. **Relevant budget restrictions (FAM 250).**
4. **Understanding of the design and implementation of each component of internal control (FAM 260).** Based on AU-C 315.42b, the auditor should document

* key elements of the understanding of each of the five internal control components, including the effect of information technology on internal control, and any identified control deficiencies;
* risk assessment procedures performed to obtain this understanding;
* sources of information from which this understanding was obtained; and
* conclusions reached on whether each component was implemented as designed.

The design and implementation of specific control activities is discussed in FAM 340 and 350, and the related documentation requirements are discussed in FAM 390. For CFO Act agencies, the auditor generally should also document the entity’s basis for its determination of substantial compliance of its financial management systems with FFMIA requirements.

1. **Audit assurance (FAM 265).** The auditor should document the audit assurance used and the auditor’s justification for it. If the audit assurance used is 95 percent, the auditor may reference the FAM.
2. **Risks of material misstatement at the financial statement level (FAM 265).** Based on AU-C 315.42d, the auditor should document the following, including the rationale for significant judgments made, if not otherwise apparent.
   * Risks of material misstatement due to error or fraud identified at the financial statement level (those that relate pervasively to the financial statements as a whole).
   * The auditor’s assessment of such risks (i.e., the auditor’s evaluation of the nature and extent of their pervasive effect on the financial statements and whether they affect the assessment of risks at the assertion level; see FAM 265.19).
   * The auditor’s overall responses to such risks (see AU-C 330.A1–.A2).
3. **Risks of material misstatement at the assertion level (FAM 265).** Based on AU-C 315.42d, the auditor should document the following, including the rationale for significant judgments made, if not otherwise apparent. The auditor may document this information in the audit strategy or refer to the LIRA form or equivalent where the information is documented (see FAM 290.09).
   * Identified risks of material misstatement due to error or fraud at the assertion level for material line items, accounts, note disclosures, and classes of transactions.
   * For each identified risk of material misstatement, the auditor’s assessment of inherent risk at one of four levels (i.e., remote, low, moderate, or high) and the basis for that assessment, including how inherent risk factors affect the susceptibility of assertions to misstatement and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework (generally U.S. GAAP) (AU-C 315.19c and .42b).
   * For each identified risk of material misstatement assessed at **low, moderate, or high**,
     + whether the risk is a significant risk (see below) and
     + the planned nature, extent, and timing of substantive procedures to address the risk and references to related audit plan steps (see FAM 400).
4. **Significant risks (FAM 265).** The auditor should document the significant risks identified. For risks of material misstatement due to **fraud** (fraud risks) that are significant risks (i.e., inherent risk is more than remote), the auditor should also document

* the type of fraud risks identified (fraudulent financial reporting or misappropriation of assets);
  + if the auditor did not identify any fraud risks relating to revenue recognition, the reasons supporting that conclusion;
  + the procedures performed to assess fraud risks, such as interviews with entity personnel regarding fraud and the brainstorming discussions noted in FAM 290.05;
  + consideration of the risk of management override of controls and other matters, such as significant abuse; and
* the effect of fraud risks on the audit strategy.

1. **Likelihood of effective IS controls and methodology used to assess them (FAM 270).** The auditor should document
   * a basic understanding of the design and implementation of IS controls and tentative conclusions on the likelihood that they are effective (the auditor documents specific IS controls in the SCE worksheet at FAM 395 G or equivalent) and
   * the methodology used for assessing IS controls and the basis for believing that it is appropriate.

As discussed in FAM 270, GAO auditors should use FISCAM as GAO believes that it is an appropriate methodology. If the auditor uses the same methodology for multiple audits, the audit organization may prepare this document once and maintain a central reference file for individual audits.

When the auditor prepares documentation of the above information, the auditor generally should obtain concurrence from an IS controls auditor. The director and assistant director, as part of their reviews of the audit strategy, should concur with the tentative conclusions on the likelihood that IS controls are effective. If the auditor determines that IS controls are not likely to be effective, the auditor should document supporting evidence and generally should report these findings as discussed in FAM 580. Due to the sensitive nature of security issues related to information systems, the auditor may include the details of these issues in a nonpublic report.

1. **Operations controls to be tested, if any (FAM 275).**
2. **Other planned audit procedures (FAM 280).**
3. **Locations to test (FAM 285).** This information includes
   * the locations selected;
   * the basis for selections;
   * the nature and timing of procedures planned for each location;
   * the determination of the number of items for testing and the allocation of those items among the selected locations (this may be initially discussed and estimated and later refined when the items are selected, particularly for a statistical sample); and
   * other procedures applied.
4. **Planned interim testing (FAM 295 D).** This information includes the basis for concluding that the use of interim testing is appropriate.
5. **Staffing and review requirements.** This information includes
   * engagement team members and specialists, who, collectively, have the appropriate competence and capabilities to perform the audit in accordance with GAGAS and enable an auditor’s report that is appropriate in the circumstances (GAGAS (2018) 4.02 and AU-C 220A.16) and
   * the nature, timing, and extent of direction and supervision of engagement team members and review of their work (AU-C 300.11).
6. **Audit timing, including milestones and the estimated date of the auditor’s report.**
7. **Extent of assistance from entity personnel.**
8. The **cycle matrix** or equivalent links material line items, accounts, note disclosures, and classes of transactions to the related significant financial management systems, LIRA forms, and cycles, as applicable (see FAM 235).
9. The **LIRA** form or equivalent contains, for each material line item, account, note disclosure, and class of transactions, the auditor’s identification and assessment of risks of material misstatement at the assertion level. The LIRA form should include all of the items listed in FAM 290.07n. If appropriate, the auditor may use one LIRA form for a material line item and all of the material accounts, note disclosures, and classes of transactions related to it. See FAM 395 H for specific instructions on preparing the LIRA form.
10. The auditor should develop an **audit plan** that includes a description of the following items:

* The nature and extent of planned risk assessment procedures sufficient to identify and assess the risks of material misstatement, as discussed in FAM 265 (AU-C 300.09a).
* The nature, extent, and timing of planned further audit procedures at the assertion level for each material line item, account, note disclosure, and class of transactions, as discussed in FAM 350 and 420 (AU-C 300.09b). The plan for further audit procedures should include (1) tests of operating effectiveness of relevant control activities identified in the SCE worksheet and (2) the nature, extent, and timing of planned substantive procedures included in the LIRA form.[[43]](#footnote-44)
* Other planned audit procedures to be carried out for the engagement to comply with GAGAS (AU-C 300.09c). See the audit completion checklist in FAM 1003, which assists the auditor with determining whether the auditor has complied with GAGAS and followed the FAM methodology.

1. Other auditor considerationsmay arise where other auditors plan to use the work being performed, as discussed in FAM 630, especially in areas where the auditor makes decisions based on significant auditor judgment. In these cases, the auditor should consider the needs of, and consult with, other auditors in a timely manner. If the auditor plans to depart from a procedure expressed by use of “should” in the FAM, the auditor should provide an opportunity for the other auditors to review the documentation of the explanations for these departures and the alternative procedures performed to achieve the requirement.
2. As audit work is performed, the auditor may become aware of possible control deficiencies; significant deficiencies; material weaknesses; noncompliance with provisions of applicable laws, regulations, contracts, and grant agreements; and misstatements, fraud, abuse, or other matters that should be communicated to the entity under audit, to the IG if the auditor is a contractor, and to those charged with governance. A structured method to document these issues aids in communicating them to the engagement team, entity management, and others soon after their discovery.

The auditor may document elements of potential findings, such as the nature of the condition and, if appropriate, the applicable criteria, cause, potential effect, and any recommendations for improvement throughout the audit. These elements and related reporting are discussed in GAGAS (2018) 6.25 through 6.28 and in FAM 580.80 through .82. The auditor may discuss these matters with entity management as the conditions are identified to inform management timely and to provide assurance that information is accurate and complete, rather than waiting until the exit conference.

295 A – Potential Inherent Risk Factors

1. Listed below are characteristics of events or conditions that may affect the susceptibility of assertions to misstatement due to fraud or error (i.e., potential inherent risk factors). Some of these may affect many accounts and assertions; others may affect only one account or assertion. Although it is not all inclusive, this section assists the auditor in assessing risks of material misstatement as discussed in FAM 265. The auditor should evaluate any other relevant factors.
2. **Nature of the Entity’s Programs and Operations**
3. Programs are significantly affected by new/changing laws and regulations, economic factors, environmental factors, or a combination of these.
4. Contentious or difficult accounting issues are associated with the administration of a significant program(s).
5. Major uncertainties or contingencies, including long-term commitments, relate to a particular program(s).
6. New (in existence less than 2 years) or changing (undergoing substantial modification or reorganization) programs lack written policies or procedures, lack adequate resources, have inexperienced managers, and generally have considerable confusion associated with them.
7. Programs that are being phased out (being eliminated within 1 or 2 years) lack adequate resources, personnel motivation, and/or interest.
8. Significant programs have a history of improper administration, affecting operating activities.
9. Significant programs have a history of inadequate financial management causing management to resort to extensive, costly, time-consuming, ad hoc efforts to prepare financial statements by the required deadline.
10. Management faces significant pressure to obtain additional funding necessary to stay viable and maintain levels of service considering the financial or budgetary position of a program, including the need for funds to finance major research and development or capital expenditures.
11. Management faces significant pressure to “use or lose” appropriated funds in order to sustain future funding levels.
12. Partisan politics between competing political parties or factions or constituent groups create conflict and a lack of stability within the entity or its programs.
13. Unusually rapid growth occurs in a program.
14. Economic conditions are deteriorating among the group served by the entity.
15. Responsibilities for significant sensitive assets or proprietary information (national security, tax, health, etc.).
16. **History of Significant Audit Adjustments**
17. The underlying cause of significant audit adjustments continues to exist.
18. **Nature of Material Transactions and Accounts**
19. New types of transactions exist.
20. Significant transactions with related parties, disclosure entities, and public-private partnerships, and/or significant unusual transactions, exist.
21. Classes of transactions or accounts are
    * difficult to audit;
    * subject to significant management judgments (such as estimates);
    * susceptible to manipulation, loss, or misappropriation;
    * susceptible to inappropriate application of an accounting policy; and
    * susceptible to problems with realization or valuation.
22. Accounts have complex underlying calculations or accounting principles.
23. Accounts have underlying activities, transactions, or events that are operating under severe time constraints.
24. Significant interagency transactions or revenue sources create incentives to shift costs or otherwise manipulate accounting transactions.
25. Accounts have activities, transactions, or events that involve the handling of unusually large cash receipts, cash payments, or wire transfers.
26. Inventory or equipment have characteristics such as small size, high value, high demand, marketability, or lack of ownership identification that make them easily converted to cash (for example, pharmaceutical inventory or military equipment with high street values).
27. Assets such as food stamps, benefits vouchers, commodities, supplies, or materials are easily converted to cash.
28. Assets such as cars, computers, and telephones are susceptible to personal, nonprogram/nongovernment use.
29. Many payments are sent to post office boxes.
30. Large numbers of payments are sent to outside recipients, as in the cases of grants, medical care reimbursements, or other federal financial assistance.

295 B – Potential Control Environment, Entity Risk Assessment, Information and Communication, and Monitoring Deficiencies

1. The specific conditions listed below may indicate deficiencies in the control environment, entity risk assessment, information and communication, and monitoring components, as well as the potential for fraud. The auditor may use this section when evaluating the design of the control environment, entity risk assessment, information and communication, and monitoring components as described in FAM 260. The auditor also may evaluate any other relevant factors and conditions. The Green Book and AU-C 315.A276 provide additional guidance for understanding these components of internal control. The auditor may evaluate these factors for the entire entity or by location.

Control Environment

1. **Communication and Enforcement of Integrity and Ethical Values (Green Book 1.01 through 1.10)**
2. Management and those charged with governance have not established, exhibited, and communicated throughout the entity an appropriate “tone at the top,” including explicit guidance about what is right and wrong.
3. Management and those charged with governance have not established a formal code of conduct or other policies regarding acceptable practices, conflicts of interest, or expected standards of ethical behavior.
4. Employees do not understand what behavior is acceptable or unacceptable, or what to do if they encounter improper behavior.
5. Management covers up bad news rather than making full disclosure as quickly as possible.
6. Management does not quickly address signs that problems exist.
7. Management and employees feel pressure to cut corners or not follow established controls.
8. High decentralization leaves top management unaware of actions taken at lower organizational levels and thereby reduces the chances of management detecting errors and fraud.
9. Everyday dealings with employees, auditors, the public, oversight groups, and others are not generally based on honesty and fairness (for example, overpayments received or supplier underpayments are ignored or efforts are made to find ways to reject legitimate claims).
10. Penalties for improper behavior are insignificant or unpublicized and thus lose their value as deterrents.
11. Management has displayed a loose attitude toward internal control, for example, by not providing guidance on when intervention is allowed or not investigating and documenting deviations from controls.
12. Management and employees feel pressure to meet performance targets or deadlines that are unrealistic.
13. Management is under undue pressure from the administration to attain an unmodified opinion on the financial statements, despite significant internal control deficiencies.
14. Management displays lack of candor in dealing with those charged with governance, oversight committee staff, recipients of the entity’s services, or auditors regarding decisions that could have an impact on the entity.
15. Management does not respond to internal and external auditors’ recommendations to strengthen internal control.
16. Management has strained relationships with the IG, its current or predecessor external auditors, or both.
17. Management does not encourage and consider employee suggestions.
18. **Commitment to Competence (Green Book 4.01 through 4.04)**
19. Management has not analyzed jobs to determine the knowledge and skills needed.
20. Employees do not seem to have the knowledge and skills they should have to do their jobs, based on the level of judgment necessary.
21. Supervision of employees does not compensate for lack of knowledge and skills in their specific jobs.
22. Inexperienced or incompetent accounting personnel are responsible for transaction processing.
23. The number of supervisors is inadequate or supervisors are inaccessible.
24. Key financial staff members have excessive workloads.
25. **Management’s Philosophy and Operating Style (Green Book 1.02 through 1.05)**
26. Management lacks concern about internal control and the environment in which specific controls function.
27. Management demonstrates an aggressive approach to risk taking.
28. Management demonstrates an aggressive approach to accounting policies. For example, management makes significant changes in allowances for uncollectible accounts that may be tied to performance measures in an effort to improve collections.
29. Management has a history of completing significant or unusual transactions near year-end, including transactions with disclosure entities, related parties, and public-private partnerships.
30. Management makes numerous adjusting journal entries, especially at year-end.
31. The process for preparing the financial statements is complex and includes many reclassifications and last-minute changes.
32. Management is reluctant to (1) consult auditors/consultants on accounting issues, (2) adjust the financial statements for misstatements, or (3) make appropriate disclosures.
33. Management displays a significant disregard for regulatory, legal, or oversight requirements or for IG, GAO, congressional authorities, or others charged with governance.
34. Top-level management lacks the financial experience/background necessary for the positions held.
35. Management is slow to respond to crisis situations in either operating or financial areas.
36. Management uses unreliable and inaccurate information to make business decisions.
37. Unexpected reorganization or replacement of management staff or consultants occurs frequently.
38. Management and personnel in key areas (such as accounting, information systems, and internal auditing) have a high turnover.
39. Individual members of top management are unusually closely identified with specific major projects.
40. Management has publicly disclosed overly optimistic information on performance of programs and activities.
41. Financial estimates consistently prove to be significantly overstated or understated.
42. Obtaining adequate audit evidence is difficult due to a lack of documentation and evasive or unreasonable responses to inquiries.
43. Financial arrangements/transactions are unduly complex.
44. There is a lack of adequate interaction between senior management and operating management, particularly those in geographically dispersed locations.
45. Management attitude toward information systems and accounting functions is that these are necessary “bean counting” functions rather than a vehicle for exercising control over the entity’s activities or making better decisions.
46. Management is motivated to engage in fraudulent financial reporting because of substantial political pressure that creates undue concern about reporting positive financial accomplishments.
47. Management is dominated, either entity-wide or at a specific component, by a single person or small group without compensating controls, such as effective oversight by those charged with governance.
48. One or more individuals with no apparent executive position(s) within the entity appear(s) to exercise substantial influence over its affairs or over individual departments or programs (for example, a major political donor or fundraiser).
49. Management has significant grantee, cooperative agreement, or contractor relationships for which there appears to be no clear programmatic or governmental justification.
50. Management appears more concerned with an unmodified opinion on the financial statements than fixing significant deficiencies in its systems.
51. Management has difficulty meeting reporting deadlines.
52. **Organizational Structure (Green Book 3.02 through 3.05)**
53. The organizational structure is inappropriate for the entity’s size and complexity. General types of organizational structures include
    * federal centralized (managed and controlled on a day-to-day basis by a centralized system),
    * federal decentralized (managed and controlled on a day-to-day basis by field offices or staffs),
    * participant administered (managed and controlled on a day-to-day basis by a nonfederal organization), and
    * other (managed and controlled on a day-to-day basis by some combination of the above or by other means).
54. The structure inhibits segregation of duties for initiating transactions, recording transactions, and maintaining custody over assets.
55. Management has difficulty determining the organization or individual(s) that control(s) the entity, parts of the entity, or particular programs.
56. Recent changes in the management structure disrupt the organization.
57. Operational responsibilities do not coincide with the divisional structure.
58. Delegation of responsibility and authority is inappropriate.
59. A lack of definition and understanding of delegated authority and responsibility exists at all levels of the organization.
60. Policies and procedures are established at inappropriate levels.
61. A high degree of manual activity or spreadsheet use is required in capturing, processing, and summarizing data to prepare financial statements.
62. A single person or a small group dominates activities.
63. Entity officials could obtain financial or other benefits based on decisions made or actions taken in an official capacity.
64. **Assignment of Authority and Responsibility (Green Book 3.06 through 3.08)**
65. The entity’s policies regarding the assignment of responsibility and the delegation of authority for matters such as organizational goals and objectives; operating functions; and regulatory requirements, including responsibility for information systems and authorizations for changes, are inadequate.
66. Appropriate control-related standards and procedures are lacking.
67. The number of people, particularly in information systems and accounting functions, with requisite skill levels relative to the size and complexity of the operations is inadequate.
68. Delegated authority is inappropriate in relation to the assigned responsibilities.
69. An appropriate system of authorization and approval of transactions (for example, in purchasing, grants, and federal financial assistance) is lacking.
70. Policies regarding physical safeguards over cash, investments, inventory, and fixed assets are inadequate.
71. **Human Resource Policies and Practices (Green Book 4.05)**
72. Human resource policies for hiring and retaining capable people are inadequate.
73. Policies and procedures for hiring, promoting, transferring, retiring, and terminating personnel are inadequate.
74. Training programs do not adequately offer employees the opportunity to improve their performance or encourage their advancement.
75. Written job descriptions and reference manuals are inadequate or inadequately maintained.
76. Communication of human resource policies and procedures at field locations is inadequate.
77. Policies on employee supervision are inappropriate or obsolete.
78. Management does not take remedial actions in response to departures from approved policies and procedures.
79. Employee promotion criteria and performance evaluations are inadequate in relation to the code of conduct.
80. Management does not adequately screen job applicants who will have access to assets susceptible to misappropriation.
81. Training regarding controls over payments to others, such as those for benefits, grants, and federal financial assistance, is inadequate.
82. Employees performing key control functions do not take vacations.
83. Management does not reassign work of key employees on vacation.
84. **Management’s Control Methods over Budget Formulation and Execution**
85. Management provides little or no guidance material and instructions to those preparing the budget information.
86. Management and employees do not understand the budget review, approval, and revision processes.
87. Management demonstrates little concern for reliable budget information.
88. Management participation in directing and reviewing the budget process is inadequate.
89. Management is not involved in determining when, how much, and for what purpose obligations and outlays can be made.
90. Management has not developed adequate planning and reporting systems that set forth management’s plans and the results of actual performance.
91. Employees use inadequate methods to identify the status of actual performance and exceptions from planned performance and communicate them to the appropriate levels of management.
92. The entity has reported noncompliance, including violations of the Antideficiency Act, and purpose, time, or other budget-related restrictions.
93. **Management’s Control Methods over Compliance with Laws, Regulations, Contracts, and Grant Agreements**
94. Management is unaware of the applicable laws, regulations, contracts, and grant agreements and potential problems.
95. A mechanism to inform management of the existence of illegal acts does not exist.
96. Management neglects to react to identified instances of noncompliance with laws, regulations, contracts, and grant agreements.
97. Management is reluctant to discuss its approach toward compliance and the reasonableness of that approach.
98. Recurring public complaints have been received through “hotline” allegations.
99. FMFIA reports; congressional reports; consultants’ reports; and prior audits/evaluations by GAO, the IG, the internal auditor, or others disclose repeated instances of noncompliance or compliance control deficiencies.
100. Management is reluctant to provide evidential matter necessary to evaluate whether noncompliance with laws, regulations, contracts, and grant agreements has occurred.
101. Management is not responsive to changes in legislative or regulatory bodies’ requirements.
102. Policies and procedures for complying with applicable laws, regulations, contracts, and grant agreements are weak.
103. Policies on matters such as acceptable business practices, conflicts of interest, and codes of conduct are weak.
104. Management does not have an effective legal counsel.
105. **Participation by Those Charged with Governance (Green Book 2.02, 2.05, and 2.06)**
106. Those charged with governance demonstrate little concern about controls and how and when management addresses internal and external auditors’ recommendations.
107. Those charged with governance have little involvement in and provide little scrutiny of activities.
108. Little interaction occurs between those charged with governance and the IG and internal and external auditors.
109. Those charged with governance demonstrate little concern for compliance with applicable laws, regulations, contracts, and grant agreements.
110. **Succession and Contingency Plans and Preparation (Green Book 4.06 through 4.08)**
111. Management does not have defined succession and contingency plans for key roles.
112. Management’s succession plan does not define key roles.
113. Management has not chosen succession candidates.
114. Management does not provide training to succession candidates before they assume the key roles.
115. Management does not assess whether the service organization can fulfill assigned responsibilities of key roles in the entity or whether the service organization can continue in these key roles.
116. Management has not defined contingency plans for assigning responsibilities if a key role in the entity is vacated.
117. **Enforce Accountability and Consider Excessive Pressure (Green Book 5.01 through 5.08)**
118. Management does not enforce accountability of individuals performing their internal control responsibilities.
119. Management does not have performance appraisals or provide disciplinary actions.
120. Management provides incentives that are not aligned with the entity’s standards of conduct.
121. Management does not hold service organizations accountable for their assigned internal control responsibilities.
122. Management does not communicate the objectives of the entity and their related risks, the entity’s standards of conduct, the role of the service organization in the organizational structure, the assigned responsibilities and authorities of the role, and the expectations of competence for its role that will enable the service organization to perform its internal control responsibilities.
123. Management does not take corrective actions to enforce accountability for internal control in the entity.
124. Management does not adjust excessive pressures on personnel in the entity.
125. Management does not evaluate pressure on personnel to help personnel fulfill their assigned responsibilities in accordance with the entity’s standards of conduct.

Entity Risk Assessment

1. **Defining Objectives (Green Book 6.02 through 6.07)**
2. Management has not defined or communicated its overall objectives to employees or those charged with governance, such as oversight committees.
3. Management does not have a strategic plan, or the strategic plan is not consistent with the entity’s objectives.
4. The strategic plan does not address high-level resource allocations and priorities.
5. The strategic plan, budgets, objectives, or a combination of these are inconsistent.
6. Management has not defined activity-level objectives for all significant activities, or the objectives are inconsistent with each other or with the overall objectives.
7. Objectives do not include measurement criteria.
8. **Identifying, Analyzing, and Responding to Risks (Green Book 7.01 through 7.09)**
9. Management does not have a formal risk assessment process.
10. For financial reporting purposes, management has not identified risks relevant to the preparation of the financial statements in accordance with U.S. GAAP. Risks relevant to reliable financial reporting also relate to specific events or transactions. See AU-C 315.A276, item 9, for examples of circumstances that could cause risks relevant to financial reporting to arise or change, such as (1) changes in the operating environment; (2) new personnel; (3) new or revamped information systems; (4) rapid growth; (5) new technology; (6) new programs, activities, strategies, or products; (7) restructuring or reorganization; (8) new accounting pronouncements; and (9) use of information technology.
11. Management has not adequately identified risks to the entity’s ability to comply with applicable laws, regulations, contracts, and grant agreements, including maintaining effective controls over compliance.
12. Management has not adequately identified risks to the entity’s ability to prevent and detect fraud.
13. Management has not adequately identified risks to achieving the entity’s objectives arising from external sources, including economic conditions, the President, the Congress, OMB, and the media.
14. Management has not adequately identified risks arising from internal sources, such as risks to human resources (ability to retain key people) or information systems (adequacy of backup systems in the event of systems failure).
15. Once risks are identified, management has not adequately analyzed the risks to estimate their significance, including considering the magnitude of impact, likelihood of occurrence, and nature of the risks.
16. Once risks are identified and analyzed, management has not adequately designed specific actions to respond to the risks.
17. **Identifying, Analyzing, and Responding to Significant Changes (Green Book 9.01 through 9.05)**
18. The mechanisms for identifying and communicating events, activities, and conditions that affect operations or financial reporting objectives are insufficient.
19. Information systems are not modified in response to changing conditions.
20. No consideration is given to designing new or alternative controls in response to changing conditions.
21. Management is unresponsive to changing conditions.

Information and Communication

1. **Use Quality Information (Green Book 13.01 through 13.06)**
2. Management has not identified all of the information requirements necessary to achieve the entity’s objectives and address risks.
3. Management uses outdated data or data from unreliable sources in its decision-making.
4. Employees are not able to understand, make use of, or timely access the information they need to complete their work assignments.
5. Management demonstrates a lack of interest in correcting information that is incomplete or inaccurate.
6. **Internal Communication (Green Book 14.01 through 14.08)**
7. The system for communicating policies and procedures is ineffective.
8. Formal or informal job descriptions do not adequately delineate specific duties, responsibilities, reporting relationships, and constraints.
9. Channels of communication for reporting suspected improprieties are inappropriate.
10. Management fails to display and communicate an appropriate attitude regarding internal control.
11. Management is not effectively communicating and supporting the entity’s accountability for public resources and ethics, especially regarding matters such as acceptable business practices, conflicts of interest, and codes of conduct.
12. Management is not receptive to employee suggestions of ways to enhance productivity and quality or control.
13. Communication across the organization (for example, between procurement and program activities) is inadequate to enable staff members to discharge their responsibilities effectively.
14. **External Communication (Green Book 15.01 through 15.09)**
15. Channels of communication with suppliers, contractors, recipients of program services, customers, and other external parties are not open and effective for communicating information on changing needs.
16. The entity’s website is not used effectively as a communication tool.
17. Outside parties have not been made aware of the entity’s ethical standards.
18. Management does not appropriately follow up on information received in communications from program service recipients, vendors, regulators, or other external parties.
19. Management has not established an open two-way line of communication with external parties to allow quality information to be sent and received.

Monitoring

1. **Ongoing Monitoring (Green Book 16.04 through 16.08)**
2. Management is not sufficiently involved in reviewing the entity’s performance or its controls.
3. Management control methods are inadequate for investigating unusual or exceptional situations and for taking appropriate and timely corrective action.
4. The entity does not have an effective hotline for reporting fraud, violations of laws and regulations, and control deficiencies.
5. The entity does not have an effective internal audit function.
6. Management’s follow-up action is untimely or inappropriate in response to communications from external parties, including complaints, notification of errors in transactions with parties, and notification of inappropriate employee behavior.
7. Management does not review whether periodic comparisons of amounts recorded in the financial management system with physical assets are performed on a timely basis and whether any differences are resolved timely.
8. Management does not monitor whether reviews to prevent large numbers of duplicate payments and other improper payments are performed on a timely basis.
9. Management does not effectively monitor that policies for developing and modifying financial management systems and control activities are reviewed on systematic basis to obtain reasonable assurance of operating effectiveness.
10. Management does not monitor the legal (or other appropriate) department’s oversight of compliance with the entity’s code of conduct, which may include employees’ periodic acknowledgment of compliance.
11. Management does not adequately monitor whether significant activities that have been outsourced to contractors or information systems components maintained by contractors are reviewed on a timely basis.
12. **Separate Evaluations under FMFIA and FFMIA**
13. Management displays a disregard for complying with FMFIA or FFMIA, or both.
14. Management displays a combative attitude toward the FMFIA or FFMIA process, or both.
15. Employees without appropriate skills manage the FMFIA or FFMIA process, or both.
16. Management did not establish an organizational structure to effectively implement, direct, and oversee the FMFIA or FFMIA process, or both. OMB Circular No. A-123 requires that entities establish a senior management council and a senior assessment team or equivalent structures. The oversight of the assessment process may also be incorporated into existing offices or functions within the organization that currently monitor the effectiveness of the organization’s internal control.
17. Management did not effectively

* evaluate controls at the entity level or consider the components of internal control based on criteria established under FMFIA (OMB Circular No. A-123 and Green Book) or
* assess whether its financial management systems comply substantially with the requirements of FFMIA based on guidance provided in OMB Circular No. A-123, appendix D.

1. Management did not include deficiencies identified in its assessments or identified by the auditor that should have been reported in its FMFIA or FFMIA reports.
2. **Management’s Assessment of Internal Control over Financial Reporting**
3. Management did not use a reasonable approach to determine the scope of the assessment. The scope of the assessment would include identifying significant financial reports, processes, controls, and transactions.
4. Management did not adequately evaluate and document the significant processes and controls, including documentation of decisions on determining the scope, materiality, testing methodology, and other significant decisions related to this assessment.
5. Management did not use a reasonable approach to determine what, when, where, and how to test controls, or did not properly document the tests and results.
6. Management did not use the results of its testing to support its conclusion on whether controls over financial reporting were designed, implemented, and operating effectively.
7. Management’s assurance statement did not appropriately describe any scope limitations and was not consistent with the evidence gathered during the testing process, including information gathered during the financial statement audit.
8. Management does not have a process in place for prompt and proper implementation of corrective actions to resolve deficiencies in internal controls, including material weaknesses.
9. Auditors note deficiencies were not included in management’s assessment of internal control over financial reporting.
10. **Reporting Deficiencies (Green Book 17.02 through 17.04)**
11. The entity does not have a mechanism for capturing and reporting identified internal control deficiencies from both internal and external sources resulting from ongoing monitoring or separate evaluations.
12. The entity does not report deficiencies to the person with direct responsibility and to a person at least one level higher or to more senior management.
13. Management does not correct deficiencies timely.
14. Management does not investigate underlying causes of problems.
15. Management does not follow up to determine whether the necessary corrective action has been taken.
16. **The Effectiveness of Other Auditors**[[44]](#footnote-45)
17. Auditors are responsible for making operating decisions or for controlling other original accounting work subject to audit.
18. Audit management personnel are inexperienced for the tasks assigned.
19. Auditors have minimal training, including little or no participation in formal courses and seminars and inadequate on-the-job training.
20. Auditors have inadequate resources to conduct audits and investigations effectively.
21. Audits are not focused on areas of highest exposure to the entity.
22. Standards against which the auditor’s work is measured are minimal or nonexistent.
23. Performance reviews of audit staff are nonexistent or irregular.
24. The audit planning process is nonexistent or inadequate, including little or no concentration on significant matters and little or no consideration of the results of prior audits and current developments.
25. Supervision and review procedures are nonexistent or inadequate, including little involvement in the planning process, in the monitoring progress, and in reviewing conclusions and reports.
26. Audit documentation, such as audit strategy, audit plans/procedures, evidence of work performed, and support for audit findings, is incomplete.
27. An inadequate mechanism is used to keep the entity head, the Congress, and others charged with governance informed about problems, deficiencies, and the progress of corrective action.
28. Audit coverage over payments made by others, such as state or local governments, for benefits, grants, and federal financial assistance is inadequate.
29. The auditor does not adequately review IS controls, including general and application controls.
30. The auditor does not use appropriate tools, such as audit software and audit sampling.
31. The audit organization does not have an adequate quality control system, including monitoring.
32. The audit organization does not have a peer review every 3 years.

295 C – An Approach for Multiple-Location Audits

1. This section provides one approach for stratifying the locations and selecting audit samples for multiple-location audits. This method assumes that the auditor has determined that it is not practical to make a centralized selection and that the auditor identifies locations to be tested each year because of identified risks of material misstatement. If the auditor uses other methods to select locations for testing, the basis for doing so must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved. The auditor generally should consult with an audit sampling specialist when selecting locations.

Stratifying the Locations

1. Unless the auditor uses a monetary unit sampling (MUS) method that automatically stratifies the population by the dollar amount of transactions, the auditor stratifies the locations by separating them into an appropriate number of relatively homogeneous groups or strata. Stratification can improve the efficiency of the audit sample result through reducing the uncertainty of the estimate by grouping items together that are expected to behave similarly with respect to the audit measure (usually misstatements). Stratification can also be used to provide items of special interest additional coverage in the audit sample. The stratification may be based on relative size or qualitative factors, such as risk of material misstatement. Criteria for stratifying may include estimates of one or more of the following relative factors:

* the dollar amount of assets;
* the dollar amounts of revenue and expenses incurred or processed at the location;
* the number of personnel, where payroll costs are significant;
* the dollar amount of appropriations;
* a concentration of specific items (such as a stratum consisting of significant inventory storage locations, of which those selected will undergo only inventory procedures);
* the nature and extent of inherent and control risk, including fraud risk and sensitive matters or the turnover of key management; and
* special reporting requirements, such as separate reports, special disclosures, or supplementary schedules.

1. For example, the auditor may stratify locations, based on the amount of total assets, into the following strata: (1) individually material locations (top stratum), (2) relatively significant locations (intermediate stratum), and (3) relatively insignificant locations (bottom stratum). If an entity has 100 locations and if the auditor determines that total assets is the relevant criterion for stratifying locations, the first three columns of table FAM 295 C.1 may represent an acceptable stratification.

Selecting Locations

1. The auditor may select locations for testing using one of the following methods for each stratum:

* **MUS or classical variables sampling method** using a multistage approach.
* **Another audit sampling method** the auditor expects will be representative. The auditor generally should consult with an audit sampling specialist if classical variables sampling or another sampling method is used.
* **Nonstatistical selection method** when the auditor determines that it is effective to select locations using auditor’s judgment. With this method, the auditor cannot project the results of the tested locations to the entity as a whole. Thus, the auditor should apply substantive analytical procedures, other substantive tests, or both to the locations not tested, unless those locations are immaterial in total to the entity as a whole.

These methods are described in more detail in FAM 480.

1. Table FAM 295 C.1 illustrates a possible MUS sample for each stratum, using performance materiality of $3 million, no expected misstatement, and 95 percent assurance. For an MUS sample, the sampling interval would be $1 million, and the preliminary estimate of the sample size would be 100 ($100 million divided by $1 million). FAM 400 provides additional information on calculating the amounts in the table and the various selection methods.

Table FAM 295 C.1: Example of MUS Sampling

| **Stratum** | **Number of locations** | **Assets** | **Preliminary estimate of sample sizea** | **Actual number of locations testedb** |
| --- | --- | --- | --- | --- |
| Top | 5 | $70,000,000 | 70 | 5 |
| Intermediate | 85 | 29,000,000 | 29 | 29 |
| Bottom | 10 | 1,000,000 | 1 | 1 |
| **Total** | **100** | **$100,000,000** | **100** | **35** |

aThe preliminary estimate of sample size is calculated by dividing the total balance by the sampling interval of $1,000,000. See FAM 400 for additional information concerning audit sampling.

bThe actual number of items tested in the top stratum may be fewer than the preliminary estimate of sample size because a top stratum selection may include more than one sample item. For example, if the implicit sampling interval is $1,000,000, a $10 million selection would include 10 sample items.

Testing the Items

1. The auditor determines the number of items to be tested at each location and then selects and tests those items. For each line item/account, the auditor determines the total number of items to be tested, based on the applicable selection method and population, tolerable misstatement, and the level of assurance desired, as described in FAM 480 and FAM 495 D.
2. The auditor may perform analytical and other procedures, as applicable, for both the locations selected and those not selected. The auditor generally should perform supplemental analytical procedures, including comparisons of locations with each other, with other years’ information, and with nonfinancial measures for all locations, regardless of the selection method.

FAM 400 provides guidance on substantive and supplemental analytical procedures. Specific matters noted during the audit—for example, cutoff misstatements at one or more locations—may warrant increased or different audit procedures at locations not previously selected for testing.

1. In evaluating the result of an audit sample, the auditor should estimate the effects, both quantitative and qualitative, on the financial statements as a whole of any misstatements noted, as discussed in FAM 480 and FAM 540. In testing selected locations, in addition to the issues concerning evaluation of audit samples in those sections, the auditor, using professional judgment, generally should apply the following additional procedures upon finding misstatements or control deviations:
2. Determine if apparent misstatements are, in fact, misstatements that have not been corrected at some level in the entity.
3. Ask management to identify the cause of the misstatements and whether similar misstatements are likely to have occurred at locations not tested.
4. Assess management’s identification of cause.
5. Determine whether the misstatements indicate that there is a control deficiency. If so, determine whether the control deficiency applies only to the location tested or to all locations. Determine whether control deficiencies indicate a need to change the control risk assessment, risk of material misstatement, or substantive procedures, either for the location or overall.
6. Obtain evidence to test management’s evaluation of whether the same or similar types of misstatement exist at other locations, including locations not tested. If the evidence is highly persuasive that the misstatement does not exist at other locations and the audit director concurs, the auditor may treat the effect on the entity the same as that on the location. See FAM 480.35 for a discussion of deciding whether evidence is highly persuasive.

If the misstatement is not isolated to the location, ask management to investigate whether there is evidence that the incidence rate throughout the entity is different from the incidence rate in the location tested. If such evidence exists, the auditor generally should obtain evidence of the incidence rate throughout the entity and determine the effect on the entity’s financial statements. If no such evidence exists, the auditor should project the misstatement identified in the location tested to the entire entity in determining the potential amount of misstatement that exists in the financial statements. The audit sampling specialist generally should review these projections.

1. The auditor should evaluate the sufficiency of audit procedures applied. The auditor should use professional judgment and should identify all relevant factors to determine whether the audit objectives are met in the specific circumstances.

295 D – Considerations for Performing Interim Substantive Testing

1. The auditor may decide to perform **substantive** tests for material line items, accounts, note disclosures, or classes of transactions as of a date before the date of the financial statements. (Note: Interim substantive testing is generally performed on statement of net cost line items or accounts.) If the auditor performs interim tests, the auditor should also apply further substantive procedures combined with tests of controls that cover the period between the interim testing date and the date of the financial statements, often referred to as the roll-forward period, and provide a reasonable basis for extending audit conclusions from the interim date to year-end.[[45]](#footnote-46)
2. Because evidence obtained as of the year-end provides more assurance than evidence obtained as of an interim date, the risk of material misstatement generally increases as the length of the roll-forward period increases. The auditor should assess the risk of material misstatement due to fraud or error (inherent risk and control risk) in determining whether substantive and control tests of the roll-forward period can be designed to provide a reasonable basis for extending the audit conclusions from the interim testing date to year-end.
3. By performing interim tests before year-end, the auditor may be able to

* more quickly address the risks of material misstatement, including audit and accounting issues, such as problem areas and complex or unusual transactions, enabling the entity to either correct misstatements or the auditor to modify the audit strategy and audit plan or procedures;
* complete the audit and issue the audit report earlier; and
* improve staff utilization and enable a smaller number of staff members to perform the audit by allocating the total audit hours over a longer period before the report issuance date.

1. Interim testing typically involves greater detection risk than testing as of year-end. However, in some cases, the auditor may be able to perform interim tests depending on the auditor’s assessment of the factors in FAM 295 D.06.
2. If the auditor finds control deviations in the tests of controls during interim tests, the auditor uses professional judgment, considering the nature, cause, and estimated effects of the deviations, to determine whether to revise the preliminary risk assessments, audit strategy, and audit plan or procedures, including decisions regarding the nature, extent, and timing of substantive procedures.
3. In determining whether to apply interim testing, the auditor should consider the following factors.

* **The assessment of risk of material misstatement.** The auditor should evaluate the risk of material misstatement during the roll-forward period, including relevant factors such as business conditions that may make management more susceptible to pressures, providing a rationale for misstating the financial statements. As the risk of material misstatement increases, the auditor generally increases the extent of the procedures applied to the roll-forward period or year-end, possibly making interim testing much more costly than only testing the year-end balances.
* **The anticipated comparability of risk of material misstatement and the nature of the items tested from the interim testing date to year-end.** The auditor may more easily extend the audit conclusions from the interim date to the year-end date if the risk of material misstatement does not increase from the interim date to the year-end date and if the nature of the items tested is similar at both dates.
* **(For balance sheet accounts) The amount of the line item or account balance at the interim testing date in relation to the expected year-end balance.** A significant increase in the line item or account balance between interim and year-end dates would diminish the auditor’s ability to extend the audit conclusions to the year-end. In addition, applying substantive interim tests to a large line item or account balance may be inefficient if the year-end balance is much lower than the balance at the interim date.
* **The length of the roll-forward period.** The longer the roll-forward period, the more difficult it is to control the increased risk of material misstatement. The auditor generally should not use a roll-forward period longer than 3 months for assertions in account balances with significant activity during the roll-forward period. However, the auditor may use a longer roll-forward period in certain situations, depending on the auditor’s assessment of the anticipated activity during the roll-forward period as discussed below.
* **The predictability of transaction activity during the roll-forward period.** Interim testing generally decreases in effectiveness and efficiency as the level of transaction activity during the roll-forward period differs from expectations, for example, if there are large or unusual transactions during this period or expected transactions did not occur.
* **The ease with which audit procedures can be applied to test the transactions or controls during the roll-forward period.** As the difficulty of such procedures increases, the efficiency of interim testing generally decreases.
* **The availability of information to test roll-forward period activity using substantive analytical procedures, detail tests, tests of controls, or a combination of procedures.** If sufficient information is not available, interim testing is not appropriate.
* **The timing of the audit, staffing and scheduling requirements, and reporting deadlines.** Tight deadlines or staff availability for performing audit procedures at the year’s end may necessitate interim testing.

1. The auditor should document in the LIRA form or equivalent the material line items, accounts, note disclosures, and classes of transactions, and the assertions, to which interim substantive testing is applied. The auditor should document the basis for concluding that the use of interim testing is appropriate in the audit strategy.
2. If interim testing is planned, see FAM 495 C for guidance for interim testing.

295 E – Effect of Risk of Material Misstatement on Extent of Audit Procedures

1. The concepts of materiality and risk interrelate and sometimes are confused. The auditor determines materiality based on the users’ perceived concerns and needs. The auditor also assesses risk of material misstatement based on, for instance, knowledge of the entity; its business (purpose); applicable laws, regulations, contracts, and grant agreements; and internal control.
2. The auditor uses both materiality and risk in (1) determining the nature, extent, and timing of audit procedures and (2) evaluating the results of audit procedures. The evaluation of risk usually **does not** affect materiality. However, risk affects the extent of testing needed. The higher the auditor's assessment of risk of material misstatement, the higher the required level of substantive assurance from the audit procedures. The consideration of inherent risk is discussed in FAM 265, and the consideration of control risk and risk of material misstatement (combined inherent risk and control risk) is discussed in FAM 370. Use of risk in determining sample size is discussed in FAM 470.
3. As an example, assume that the auditor is testing accounts receivable using MUS techniques described in FAM 480. Pertinent data for this test are

* accounts receivable total $2.5 million,
* tolerable misstatement is $100,000, and
* no misstatements are expected.

If the auditor assesses risk of material misstatement as low, the sample size would be 25 items. If the auditor assesses the risk of material misstatement as high, the sample size would be 75 items. The increase in risk tripled the sample size **with the same tolerable misstatement**.

295 F – Types of Information System Controls

1. As discussed in FAM 270, when relevant control activities depend on information system processing, the auditor should assess IS controls using an appropriate methodology. The auditor should understand the design of the general controls identified to the extent necessary to conclude tentatively whether these controls are likely to be effective. If they are likely to be effective, the auditor should test IS controls using an appropriate methodology (see FAM 360). An information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls.
2. IS controls consist of those internal controls that are dependent on information system processing and can be classified into three types:

* general controls,
* application controls, and
* user controls.

General Controls

1. General controls (implemented at the entity-wide, system, and application levels) are the structure, policies, and procedures that apply to all or a large segment of an entity’s information systems, including financial management systems. General controls help ensure the proper operation of information systems by creating the environment for effective operation of application controls. Ineffective general controls may prevent application controls from operating effectively and allow misstatements to occur and not be detected. General controls include the following:
2. **Security management** is the foundation of a security-control structure and is a reflection of senior management’s commitment to addressing security risks. Security management programs should provide a framework and continuous cycle of activity for managing risk, developing and implementing effective security policies, assigning responsibilities, and monitoring the adequacy of the entity’s IS controls. Without a well-designed security management program, security controls may be inadequate; responsibilities may be unclear, misunderstood, or improperly implemented; and controls may be inconsistently applied. Such conditions may lead to insufficient protection of sensitive or critical resources and disproportionately high expenditures for controls over low-risk resources.
3. **Logical and physical access controls** limit access or detect inappropriate access to computer resources (data, programs, equipment, and facilities), thereby protecting these resources against unauthorized modification, loss, and disclosure. Logical access controls require users to authenticate themselves (through the use of one or more authentication tokens such as passwords, smart cards, biometric data, etc.) and limit the files and other resources that authenticated users can access and the actions that they can execute. Physical access controls involve restricting physical access to computer resources and protecting them from intentional or unintentional loss or impairment.
4. **Configuration management** involves the identification and management of security features for all hardware, software, and firmware[[46]](#footnote-47) components of an information system at a given point and systematically controls changes to that configuration during the system’s life cycle. Configuration management controls that are designed and implemented effectively prevent unauthorized or untested changes to critical information system resources at each system sublevel (i.e., network, operating systems, and infrastructure applications) and provide reasonable assurance that systems are securely configured and operated as intended.

In addition, configuration management controls that are designed and implemented effectively provide reasonable assurance that software programs and changes to software programs go through a formal, documented systems development process that identifies all changes to the baseline configuration. To reasonably assure that changes to applications are necessary, work as intended, and do not result in the loss of data or program integrity, such changes should be authorized, documented, tested, and independently reviewed.

1. **Segregation of duties** includes having policies, procedures, and an organizational structure to manage who can control key aspects of computer-related operations and thereby prevents unauthorized actions or unauthorized access to assets or records. Segregation of duties involves segregating work responsibilities so that one individual does not control all critical stages of a process. Effective segregation of duties is achieved by splitting responsibilities between two or more individuals or organizational units. In addition, dividing duties this way diminishes the likelihood that errors and wrongful acts will go undetected because the activities of one group or individual will serve as a check on the activities of the other.
2. **Contingency planning** protects critical and sensitive data and provides for critical operations to continue without disruption or be promptly resumed when unexpected events occur. Contingency planning involves protecting against losing the capability to process, retrieve, and protect electronically maintained information. Effective contingency planning is achieved by having procedures for protecting information resources and minimizing the risk of unplanned interruptions and a plan to recover critical operations should interruptions occur. In addition, recovery plans should be tested periodically in disaster simulation exercises to determine whether they will work as intended.

FISCAM has detailed guidance on evaluating and testing general controls.

1. General controls are established at the entity-wide, system, and application levels.

* In evaluating general controls at the entity-wide or system level, the auditor and the IS controls auditor may evaluate overall access control. For instance, the IS controls auditor may evaluate the entity’s use of security access software that provides authentication services to multiple systems, including its proper implementation.
* When evaluating general controls at the application level, the auditor and the IS controls auditor may evaluate access controls that limit access to particular applications and related computer files, such as restricting access to payroll applications and related files (such as the employee master file and payroll transaction files) to authorized users.
* Finally, the auditor and the IS controls auditor may evaluate the security built into the application itself to further restrict access. This security is usually accomplished through menus and other restrictions programmed into the application software. Thus, a payroll clerk may have access to payroll applications but may be restricted from access to a specific function, such as reviewing or updating payroll data on payroll department employees.

1. The effectiveness of general controls is a significant factor in determining the effectiveness of application controls and certain user controls. Without effective general controls, application controls may be rendered ineffective by circumvention or modification. For example, the production and review of an exception report of unmatched items can be an effective application control. However, this control would be ineffective if the general controls permitted unauthorized program modifications such that certain items would be inappropriately excluded from the report.

Application Controls

1. Application controls are controls that are incorporated directly into software programs, or applications, to help ensure the validity, completeness, accuracy, and confidentiality of transactions and data during information system processing. Application controls, sometimes referred to as business process controls, include controls over

* input,
* processing,
* output,
* master data,
* application interfaces, and
* data management system interfaces.

The effectiveness of application controls depends on the effectiveness of entity-wide and system-level general controls. Deficiencies in entity-wide and system-level general controls can permit unauthorized changes to business process applications and data that can circumvent or impair the effectiveness of application controls. An effective application control environment includes

* general controls implemented at the application level (i.e., security management, access controls, configuration management, segregation of duties, and contingency planning);
* controls over transaction data input, processing, and output as well as master data maintenance;
* interface controls over the timely, accurate, and complete processing of information between information systems; and
* controls over the data management systems.

1. FISCAM uses control categories that complement the methodology used in the FAM. Most of the following categories relate to the assertions.

* **Validity controls.** This category relates to the assertion of existence or occurrence. Validity controls provide reasonable assurance (1) that all recorded transactions actually occurred (are real), relate to the organization, and were properly approved in accordance with management’s authorization and (2) that output contains only valid data. A transaction is valid when it has been authorized (for example, buying from a particular supplier) and when the master data relating to that transaction are reliable (for example, the name, bank account, and other details on that supplier). Validity includes the concept of authenticity, including prevention or detection of duplicate transactions. Examples of validity controls are one-for-one checking and matching.
* **Completeness controls.** This category relates to the assertion of completeness and deals with whether all valid transactions are recorded. Completeness controls provide reasonable assurance that all transactions that occurred are input into the system, accepted for processing, processed once and only once by the system, and properly included in output. Completeness controls include the following key elements:
  + transactions are completely input;
  + valid transactions are accepted by the system;
  + rejected transactions are identified, corrected, and reprocessed; and
  + all transactions accepted by the system are processed completely.

The most common completeness controls in applications are batch totals, sequence checking, matching, duplicate checking, reconciliations, control totals, and exception reporting. Reconciliations not only help detect misstatements relating to transaction completeness, but also identify the cutoff and summarization misstatements associated with both the existence or occurrence and completeness assertions.

* **Accuracy controls.** This category relates to the assertion of valuation or allocation, which deals with whether transactions are recorded at correct amounts. This control category, however, is not limited to valuation and also includes controls designed to properly classify transactions. Accuracy controls should provide reasonable assurance that transactions are properly recorded, with the correct amounts/data, and on a timely basis (in the proper period); key data elements input for transactions are accurate; data elements are processed accurately by applications that produce reliable results; and output is accurate.

Accuracy control techniques include programmed edit checks (e.g., validations, reasonableness checks, dependency checks, existence checks, format checks, mathematical accuracy, range checks, etc.); batch totals; and check digit verification.

* **Confidentiality** **controls.** These controls should provide reasonable assurance that application data and reports and other output are protected against unauthorized access. Examples of confidentiality controls include restricted physical and logical access to sensitive business process applications, data files, transactions, and output and adequate segregation of duties. Confidentiality controls also include restricted access to data reporting/extraction tools as well as copies or extractions of data files.
* **Availability controls.** These controls should provide reasonable assurance that application data and reports and other relevant business information are readily available to users when needed. These controls are principally addressed in application-level general controls (especially contingency planning).

User Controls

1. User controls are portions of controls that are performed by people interacting with information systems. The effectiveness of a user control typically depends on information system processing or the reliability of information that information systems produce. A user control is considered both an IS control and a manual control if it depends on information system processing. For example, the effectiveness of a user control to review and follow up on exceptions typically depends on the reliability of the exception report that the information system produces through information system processing.

A user control is considered a manual control if it does not depend on information system processing. For example, the effectiveness of a user control to manually reconcile information that information systems produce may or may not depend on the reliability of the information used in the reconciliation, depending on the nature of the control. Additionally, the effectiveness of a user control to monitor the effective functioning of information systems and IS controls may or may not depend on the reliability of information that information systems produce.

If the auditor expects the effectiveness of a user control to reduce the risk of material misstatement, the auditor should understand the design of and test any related controls that support achieving the control objective of the user control. The extent to which it is necessary to assess related IS controls depends on the design of the user control and its control objective.

For example, if the user control is the review of an exception report, the auditor would obtain an understanding of the design of and test the application controls directly related to the production of the exception report, as well as the general and other application controls upon which the reliability of the information in the exception report depends. This testing would include controls over the design and proper functioning of the business processes that generate the exception report and the reliability of the data used to generate the exception report. In addition, the auditor would test the effectiveness of the user control (i.e., management review and follow-up on the items in the exception report).

If the user control is a manual reconciliation of information that information systems produce, the auditor should obtain an understanding of the sources of the information being reconciled and how such information is produced to evaluate the design of the user control. Depending on the design of the manual reconciliation and its control objective, the auditor may or may not need to assess the application and general controls related to producing the information being reconciled. For example, the auditor may not need to assess the application or general controls related to producing the information being reconciled if the control objective is to provide an independent check on the validity, accuracy, and completeness of the information system–processed data and the manual reconciliation is effectively designed to achieve this objective.

1. In certain circumstances, user controls may be manual controls used to monitor the proper functioning of information systems and IS controls. For example, a user control to manually check the completeness and accuracy of information system processed transactions against manually prepared source records would be considered a manual control. However, it is important to note that the effectiveness of this manual control would be dependent on the effectiveness of the manual controls over the reliability of the manually prepared source records.

295 G – Budget Controls

1. Budget controls are management’s policies and procedures for managing and controlling the use of appropriated funds and other forms of budget authority. Budget controls are part of the internal controls covered in OMB audit guidance. During planning, the auditor should obtain an understanding of budget controls, as discussed in FAM 250 and 260.
2. Certain controls may achieve both financial reporting and other control objectives. Accordingly, for efficiency, the auditor may coordinate obtaining an understanding of budget controls with obtaining an understanding of financial reporting, compliance, and relevant operations controls.
3. **Budget authority** is authority provided by law to allow federal entities to enter into financial obligations that will result in immediate or future outlays involving government funds. The Congress provides an entity with budget authority and may place restrictions on the amount, purpose, and timing of the obligation or outlay of such authority.
4. There are four basic forms of budget authority:

* **Appropriations.** The most common form of budget authority, appropriations are statutory authority that permits federal entities to incur obligations and to make payments from the Treasury for specified purposes. Appropriations do not represent cash actually set aside in the Treasury for purposes specified in the appropriation acts. Appropriations represent amounts that entities may obligate during the period specified in the appropriation acts. Periods can be single year, multiyear, or no year.
* **Borrowing authority.** This is statutory authority that permits federal entities to borrow money and then to obligate against amounts borrowed. The amount to be borrowed may be definite or indefinite in nature, and the purposes for which the borrowed funds are to be used are stipulated by the authorizing statute.
* **Contract authority.** This is statutory authority that permits obligations to be incurred in advance of appropriations or in anticipation of receipts to be credited to a revolving fund or other account (offsetting collections). Contract authority is unfunded. Subsequent funding by an appropriation or by offsetting collections is needed to liquidate the obligations incurred under the contract authority.
* **Offsetting receipts and collections authority.** This is statutory authority that permits federal entities to obligate and expend the proceeds of offsetting receipts and collections. Offsetting receipts and collections are of a business-market-oriented nature and may include intragovernmental transactions, such as reimbursements for materials or services provided to other government entities. If, pursuant to law, they are credited to appropriations or fund expenditure accounts and are available for obligation without further congressional action, they are referred to as offsetting collections.

1. Although the Congress provides budget authority to some federal entities annually in the appropriations act process, the Congress provides other federal entities with budget authority through laws other than annual appropriations acts, or through permanent authorities that permit the entity to spend budget authority without further congressional action.
2. For additional information and terminology on the federal budget process, consult GAO’s *A Glossary of Terms Used in the Federal Budget Process* (GAO‑05‑734SP, September 2005).

295 H – List of General Laws

1. The auditor should determine whether the significant provisions in the following laws have a direct effect on determining material amounts and disclosures in the financial statements (see FAM 245.03). The auditor generally should use the General Compliance Checklist in FAM 802 or equivalent to determine which of these legal provisions are significant for testing compliance. Following each listed law is the section in the FAM that contains the compliance summary for internal control testing and audit procedures for that law.
2. **Antideficiency Act (ADA**), as providedprimarily in 31 U.S.C. chapters 13, 15. Provisions: 31 U.S.C. §§ 1341(a)(1)(A), (B); and 31 U.S.C. § 1517(a). See FAM 803.
3. **Federal Credit Reform Act of 1990 (FCRA)**, as provided in 2 U.S.C. §§ 661-661f. Provisions: 2 U.S.C. § 661c(b), (e). See FAM 804.
4. **Federal Debt Collection Authorities**, as provided in 31 U.S.C. chapter 37. Provisions: 31 U.S.C. § 3711; 31 U.S.C. § 3717(a), (b), (c), (e), (f); and 31 U.S.C. § 3719. See FAM 805.
5. **Prompt Payment Act (PPA)**, as provided in 31 U.S.C. chapter 39. Provisions: 31 U.S.C. § 3902(a), (b), (f); and 31 U.S.C. § 3904. See FAM 806.
6. **Pay and Allowance System for Civilian Employees**, as provided primarily in 5 U.S.C. chapters 51-59. Provisions: 5 U.S.C. § 5332; 5 U.S.C. § 5343; 5 U.S.C. § 5376; and 5 U.S.C. § 5383. See FAM 807.
7. **Civil Service Retirement Act (CSRA)**, as provided in 5 U.S.C. chapter 83. Provisions: 5 U.S.C. chapter 83, subchapter III. See FAM 808.
8. **Federal Employees Health Benefits Act (FEHBA)**, as provided in 5 U.S.C. chapter 89. Provisions: 5 U.S.C. chapter 89. See FAM 809.
9. **Federal Employees' Compensation Act (FECA)**, as provided in 5 U.S.C. chapter 81. Provisions: 5 U.S.C. chapter 81, subchapter I. FAM 810.
10. **Federal Employees’ Retirement System Act (FERSA)**, as provided in 5 U.S.C. chapter 84. See FAM 811.

295 I – Examples of Auditor Responses to Fraud Risks

1. As discussed in FAM 265, the auditor should respond to the risks of material misstatement due to fraud (fraud risks) at the financial statement and assertion levels. This section provides examples of auditor responses to fraud risks, including changing the nature, extent, or timing of audit procedures.

Examples of Auditor Responses to Fraud Risks Involving the Nature, Extent, or Timing of Audit Procedures

1. Examples of auditor responses to fraud risks involving the nature, extent, or timing of audit procedures include the following:
2. Inquiring of management and other personnel involved in areas having fraud risks, such as risks related to any improper payments, to obtain their insights about those risks and whether and how controls mitigate those risks.
3. Inquiring of management regarding management’s understanding of and response to the fraud risks that may exist at the entity’s service organizations.
4. Inquiring of those charged with governance to obtain their insights about those risks and whether and how controls mitigate those risks.
5. Inquiring of additional members of management, such as program directors or center directors, or other nonaccounting personnel to assist in identifying issues and corroborating other evidential matter.
6. Using data-mining or other computer-assisted audit techniques to gather more extensive evidence about data contained in significant accounts. For example, the auditor can use computer software, such as Interactive Data Extraction and Analysis (IDEA), to select audit sample items from electronic files, locate items with specific characteristics (to perform substantive analytical procedures or make a nonstatistical selection), or test an entire population.[[47]](#footnote-48)
7. Inspecting, or observing physical counts of, tangible assets (such as property, plant, and equipment) and certain inventories, for which other procedures may otherwise have been sufficient.
8. Conducting surprise or unannounced procedures, such as inventory inspections or cash counts on unexpected dates or at unexpected locations.
9. Inquiring of major suppliers or customers in addition to obtaining written confirmations, requesting confirmations of specific individuals within an organization, or requesting confirmation of additional or different information.
10. Where a specialist’s work is particularly significant (see FAM 620 and AU-C 620), performing additional procedures related to some or all of the specialist’s methods, assumptions, or findings to evaluate whether the findings are unreasonable, or engaging another specialist to do that.
11. Performing additional or more focused tests of budget to actual variances and their underlying causes.
12. Performing targeted tests of the timing of cost/expense recognition.
13. Requesting that physical inventory counts be made on or closer to year-end.
14. If fraud risks relate to an interim period, performing audit tests that are focused on transactions that occurred in that interim period (or throughout the reporting period).
15. Testing a larger audit sample of disbursement transactions for validity.
16. Performing substantive analytical procedures that are more detailed by location, program, month, or other category (for example, analyzing specific credit lines in an allowance for loan losses, rather than the portfolio as a whole), or that use more precise techniques (for example, regression analysis).
17. Discussing with other auditors who are auditing the financial statements of one or more entity components the extent of work necessary to address fraud risks resulting from intragovernmental transactions and activity among those components.

Additional Examples of Auditor Responses to Fraud Risks Related to Fraudulent Financial Reporting

1. The following paragraphs provide additional examples of auditor responses to fraud risks related to misstatements arising from fraudulent financial reporting in the areas of (1) accounting estimates, (2) revenue recognition, and (3) inventory quantities. These example responses involve the nature, extent, and timing of audit procedures.

Accounting Estimates

1. Fraud risks may relate to management’s development of accounting estimates. These risks may affect various accounts and assertions, such as valuation and completeness of liabilities related to insurance and credit programs, pensions, postretirement benefits, and environmental cleanup. These risks may also relate to significant changes in assumptions for recurring estimates. Further, because estimates are based on both subjective and objective factors, bias may exist in the subjective factors.
2. Examples of procedures that the auditor may perform in response to fraud risks related to accounting estimates include the following:
3. Gathering additional information about the entity and its environment to assist in more extensively evaluating the reasonableness of accounting estimates and underlying judgments and assumptions, focusing on more sensitive or subjective aspects.
4. Performing a more extensive retrospective review of management judgments and assumptions applied in estimates made for prior periods. This could encompass analyzing each significant judgment and assumption in light of the events that occurred subsequently. The auditor may then identify (with management’s assistance) reasons for any differences and whether these reasons apply to current period estimates.
5. Using the work of a specialist to evaluate an accounting estimate, or developing an independent estimate to compare to the accounting estimate.

Revenue Recognition

1. Revenue recognition is affected by the particular facts and circumstances and sometimes—for example, for certain government corporations—by accounting principles that vary by type of operations. Hence, where revenue is (or is expected to be) material, the auditor should understand the criteria for revenue recognition that the entity uses and should design audit procedures based on the entity’s operations and its environment, including the composition of revenue, specific attributes of the revenue transactions, and any other specific entity considerations.
2. Examples of procedures that the auditor may perform in response to fraud risks related to improper revenue recognition include the following:
3. Performing substantive analytical procedures related to revenue that are based on more precisely developed expectations, such as comparing revenue between the current year and expectations by location, program, and month, or that establish the limit (see FAM 475.04–.05) at a lower percentage of tolerable misstatement. Audit techniques such as regression analysis may be helpful in performing these procedures.
4. Inquiring of entity personnel, including its general counsel, about any revenue-related transactions near the end of the reporting period and their knowledge of any unusual terms or conditions that may be related to those transactions.
5. Confirming with customers and other appropriate parties the relevant contract terms and the absence of side agreements that may influence the appropriate accounting.
6. Physically observing goods being shipped or readied for shipment (or returns awaiting processing) at one or more locations at the end of the reporting period and performing appropriate sales and inventory cutoff procedures.
7. Expanding tests of general and application controls related to revenue transactions that are electronically initiated, processed, and recorded.

Inventory Quantities

1. Examples of procedures that the auditor may perform in response to fraud risks related to inventory quantities include the following:
2. Reviewing the entity’s inventory records to identify locations, items, or issues that warrant attention during or after the physical inventory count. As a result of this review, the auditor may decide to observe inventory counts at some locations on an unannounced basis or to request that physical inventory counts be made at all locations on the same date on, or closer to, year-end.
3. Performing additional inventory inspection procedures, such as more rigorously examining the contents of boxed items; the manner in which the inventory is stacked (to identify hollow squares or other issues) or labeled; and—using the work of a specialist, if needed—the purity, grade, and concentration of inventory substances, such as specialty chemicals.
4. Performing additional tests of physical inventory count sheets or tags, and retaining copies of these documents to minimize the risk of subsequent alteration or inappropriate extension and summarization of the inventory.
5. Performing additional procedures focused on the quantities included in the priced inventory to further test the count quantities—such as comparing quantities for the current period with those for prior periods by inventory category, location, or other criteria, or comparing count quantities with perpetual records.
6. Using computer-assisted audit techniques to test the extension and summarization of the physical inventory counts—such as sorting by tag number to test tag controls or by item number to test for item omission or duplication—and to test for unusual quantities and cost amounts.
7. Establishing the limit (see FAM 475.04–.05) at a lower percentage of tolerable misstatement when performing substantive analytical procedures related to inventories.

Additional Examples of Auditor Responses to Fraud Risks Related to Misappropriation of Assets

1. Additional examples of auditor responses to fraud risks related to misstatements arising from misappropriation of assets involving the nature, extent, and timing of audit procedures include the following:
2. Using information on improper payments, including information from entity review of programs and activities under PIIA, to develop and perform audit procedures focused on specific vulnerable areas.
3. Expanding the extent of participant-eligibility testing for benefit programs to encompass unannounced visits to intake centers or work sites to test the existence and identity of participants, to observe benefit payment distribution to identify “ghost” or deceased participants, or to use confirmation requests to test the existence of program participants. The auditor may also use data mining to search for duplicate payments; ineligible, ghost, or deceased participants; and other issues.
4. Obtaining a more comprehensive understanding of internal controls for assets that are highly susceptible to misappropriation, in order to identify relevant controls to prevent and detect a misappropriation; expanding the tests of those controls; and physically inspecting those assets at or near the end of the reporting period.
5. Assigning higher inherent risk to locations that have higher fraud risks (when, for example, large quantities of assets that are particularly susceptible to such risks are present), and modifying substantive procedures at those locations.
6. Establishing the limit (see FAM 475.04–.05) at a lower percentage of tolerable misstatement when performing substantive analytical procedures related to assets that are particularly susceptible to misappropriation.

295 J – Steps in Assessing Information System Controls

1. As discussed in FAM 270, the following flowcharts illustrate steps the auditor and the IS controls auditor generally follow in understanding and assessing IS controls in a financial statement audit. However, the engagement team may decide to test the effectiveness of the general controls even if they are not likely to be effective (see fig. 1) or review application controls even though general controls are not effective (see fig. 2), in order to make recommendations on how to fix weak controls.

**Figure 1: Steps in Assessing Information System (IS) Controls in a Financial Statement Audit**

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Usually done by IS controls auditor

in consultation with auditor

Usually done by auditor in consultation

with IS controls auditor

**Figure 2: Steps for Each Significant Application in Assessing Information System (IS) Controls in a Financial Statement Audit**

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Usually done by IS controls auditor

in consultation with auditor

Usually done by auditor in consultation

with IS controls auditor

1. In the FAM, “applicable laws, regulations, contracts, and grant agreements” refers to those laws, regulations, contracts, and grant agreements that are applicable to the audited entity. [↑](#footnote-ref-2)
2. Management refers to the persons with executive responsibility for the conduct of the entity’s operations. For some entities, management includes some or all of those charged with governance, for example, senior executives. [↑](#footnote-ref-3)
3. Those charged with governance refers to those who have the responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity’s financial reporting process. Accordingly, for these purposes, those charged with governance are considered part of the entity’s internal control and may be members of a board or commission, an audit committee, the secretary of a cabinet-level department, or senior executives and financial managers responsible for the entity. Although *Standards for Internal Control in the Federal Government* (known as the Green Book) uses “oversight body” (defined as “Those responsible for overseeing management’s design, implementation, and operation of an internal control system (paragraph OV2.14).”), the FAM uses “those charged with governance” throughout. [↑](#footnote-ref-4)
4. Note to auditor: 20X2 denotes the current year, and 20X1 denotes the prior year, under audit. [↑](#footnote-ref-5)
5. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected, on a timely basis. [↑](#footnote-ref-6)
6. Note to auditor: Procedures related to disclosure entities and public-private partnerships do not apply to entities issuing financial statements in accordance with FASB accounting standards. [↑](#footnote-ref-7)
7. Note to auditor: Statement of Federal Financial Accounting Concepts (SFFAC) 1 issued by FASAB provides a slightly different definition of materiality. Since SFFACs are nonauthoritative, and in SFFAC 1, the board recognizes differences from the audit definition, the FAM is based on the definition provided in AU-C 200.07. [↑](#footnote-ref-8)
8. Note to auditor: If applicable, include sentence to add tests of laws and regulations listed in OMB audit guidance that the auditor deems applicable to the financial statements. [↑](#footnote-ref-9)
9. Note to auditor: 20X2 denotes the current year, and 20X1 denotes the prior year, under audit. [↑](#footnote-ref-10)
10. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected, on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. [↑](#footnote-ref-11)
11. Note to auditor: Procedures related to disclosure entities and public-private partnerships do not apply to entities issuing financial statements in accordance with FASB accounting standards. [↑](#footnote-ref-12)
12. Note to auditor: Statement of Federal Financial Accounting Concepts (SFFAC) 1 issued by FASAB provides a slightly different definition of materiality. Since SFFACs are nonauthoritative, and in SFFAC 1, the board recognizes differences from the audit definition, the FAM is based on the definition provided in AU-C 200.07. [↑](#footnote-ref-13)
13. Note to auditor: In the event that no material weaknesses were identified during the audit, OMB audit guidance requires the auditor to state, in the report on internal control over financial reporting, that no deficiencies in internal control were identified during the audit that were considered to be material weaknesses. [↑](#footnote-ref-14)
14. Sample engagement letter from FAM 215 A. [↑](#footnote-ref-15)
15. Understanding how inherent risk factors affect the susceptibility of assertions to misstatement may assist the auditor with a preliminary understanding of the likelihood or magnitude of misstatements, which assists the auditor in identifying risks of material misstatement at the assertion level in accordance with FAM 265.11b. Understanding the degree to which inherent risk factors affect susceptibility of assertions to misstatement also assists the auditor in assessing the likelihood and magnitude of a possible misstatement when assessing inherent risk in accordance with FAM 265.22a. (AU-C 315.A95) [↑](#footnote-ref-16)
16. Under Federal Accounting Standards Advisory Board (FASAB) standards, organizations are considered to be related parties if the existing relationship or one party to the existing relationship has the ability to exercise significant influence over the other party’s policy decisions. In the federal government, there are additional relationships that present risks similar to related parties, as defined by FASAB. These include disclosure entities and public-private partnerships. Consequently, while the AICPA auditing standards address only related parties, the auditor should apply audit procedures required for related parties to disclosure entities and public-private partnerships. Note that FASAB and the Financial Accounting Standards Board (FASB) provide different definitions for related parties. Procedures pertaining to disclosure entities and public-private partnerships do not apply to entities issuing financial statements in accordance with FASB accounting standards. [↑](#footnote-ref-17)
17. In the FAM, control activities include controls within the control environment, entity risk assessment, information and communication, and monitoring components that directly address risks of material misstatement at the assertion level (see FAM 360.19). [↑](#footnote-ref-18)
18. AU-C 315 discusses audit procedures for classes of transactions, account balances, and disclosures. The FAM uses line item to describe an aggregation of account balances. The FAM refers to information in the notes to the financial statements as note disclosures. [↑](#footnote-ref-19)
19. GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](https://www.gao.gov/greenbook) (Washington, D.C.: September 2014). [↑](#footnote-ref-20)
20. FMFIA was repealed, but provisions remain codified at 31 U.S.C. § 3512(c), (d). These provisions are still commonly referred to as FMFIA. Because of the common usage of the act’s name, the FAM will continue to refer to FMFIA. However, auditors should correctly cite the applicable provisions in their reports. See FAM 595 A. [↑](#footnote-ref-21)
21. Statement of Federal Financial Accounting Concepts (SFFAC) 1, *Objectives of Federal Financial Reporting*, issued by FASAB provides a slightly different definition of materiality. Since SFFACs are nonauthoritative, and in SFFAC 1, the board recognizes differences from the audit definition, the FAM is based on the definition provided in AU-C 200.07. [↑](#footnote-ref-22)
22. Per OMB reporting guidance, the reconciliation of net cost to net outlays may be presented as a financial statement or note to the financial statements. [↑](#footnote-ref-23)
23. Other data include information that is recorded along with the transaction amount and are necessary for the proper recording of the transaction, such as transaction description, transaction date, trading partner, cost center, fund code, and other accounting codes the entity uses. [↑](#footnote-ref-24)
24. For each AU-C 315 assertion listed in the left column, the table lists the related FAM 235 assertion(s) in the right column, with the corresponding aspects of the assertion(s) in **bold** font. [↑](#footnote-ref-25)
25. Internal control as defined in the Green Book is a process effected by an entity’s oversight body, management, and other personnel that provides reasonable assurance that the objectives of the entity will be achieved. [↑](#footnote-ref-26)
26. AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, identifies the five components of internal control as control environment, the entity’s risk assessment process, the entity’s process to monitor the system of internal control, the information system and communication, and control activities. The components in AU-C 315 are described in the context of a financial statement audit, whereas GAO’s Green Bookdefines the components in the context of internal control overall. The FAM’s descriptions of internal control components are generally aligned with the Green Book, which is specific to federal entities. [↑](#footnote-ref-27)
27. “Control activities” as used in the FAM are referred to as controls in the control activities component in AU-C 540, *Auditing Accounting Estimates and Related Disclosures*. [↑](#footnote-ref-28)
28. In obtaining an understanding of how information relating to material line items, accounts, note disclosures, and classes of transactions flows into, through, and out of the entity’s information processes, the auditor may also identify controls that are evaluated as part of the control activities component, especially related to information technology. The Green Bookprimarily discusses controls related to information technology in the control activities component*.*  [↑](#footnote-ref-29)
29. The “information and communication component” discussed in the FAM is referred to as the information system and communication component in AU-C 315. [↑](#footnote-ref-30)
30. This includes the information technology applications and supporting information technology infrastructure, as well as the information technology processes and personnel involved in those processes, that an entity uses to support its operations and achieve strategic objectives. [↑](#footnote-ref-31)
31. FMFIA was repealed, but provisions remain codified at 31 U.S.C. § 3512(c), (d). These provisions are still commonly referred to as FMFIA. Because of the common usage of the act’s name, the FAM will continue to refer to FMFIA. However, auditors should correctly cite the applicable provisions in their reports. See FAM 595 A. [↑](#footnote-ref-32)
32. Audit assurance is not the same as statistical confidence. Audit assurance is a combination of quantitative measurement and auditor judgment. [↑](#footnote-ref-33)
33. In the FAM, control activities include controls within the control environment, entity risk assessment, information and communication, and monitoring components that directly address risks of material misstatement at the assertion level (see FAM 360.19). [↑](#footnote-ref-34)
34. The spectrum of inherent risk refers to the scale on which the level of inherent risk varies (AU-C 315.12). The assessed level of inherent risk for an identified risk of material misstatement at the assertion level represents a judgment within a range, from low to high, on the spectrum of inherent risk (AU-C 315.A239). [↑](#footnote-ref-35)
35. Based on AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, the auditor should perform substantive procedures for classes of transactions, account balances, and disclosures for which there is one or more identified risks of material misstatement for which inherent risk is more than remote. The FAM expands on the AU-C 330 requirement to include performing substantive procedures for all material line items, accounts, note disclosures, and classes of transactions. As a result, the stand-back requirement in AU-C 315.40 does not apply. [↑](#footnote-ref-36)
36. AU-C 315 states that an identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk is a significant risk. The spectrum of inherent risk per AU-C 315 is the degree to which the level of inherent risk varies. Based on AU-C 315, the FAM considers any identified risks of material misstatement assessed at high to be a significant risk. [↑](#footnote-ref-37)
37. Significant improper payments are those that may have exceeded either (1) $10 million and 1.5 percent of program outlays or (2) $100 million regardless of percentage of program outlays. [↑](#footnote-ref-38)
38. “Relevant controls” or “relevant control activities” as used in the FAM are referred to as identified controls or controls that address the risks of material misstatement at the assertion level in AU-C 315. [↑](#footnote-ref-39)
39. An information technology specialist differs from an IS controls auditor. An information technology specialist possesses special skills or knowledge in the information technology field that extend beyond the skills and knowledge normally possessed by those working in specialized fields of auditing, such as IS controls auditing. Auditors and IS controls auditors may decide to seek the assistance of an information technology specialist to complete various aspects of the engagement. [↑](#footnote-ref-40)
40. In the federal government, in-house legal counsel generally has primary responsibility for the entity’s legal matters and thus is most knowledgeable about the entity’s litigation, claims, and assessments. [↑](#footnote-ref-41)
41. In the federal government, the main legal counsel outside of the entity is the Department of Justice. [↑](#footnote-ref-42)
42. Procedures related to disclosure entities and public-private partnerships do not apply to entities issuing financial statements in accordance with FASB accounting standards. [↑](#footnote-ref-43)
43. In the FAM, control activities include controls within the control environment, entity risk assessment, information and communication, and monitoring components that directly address risks of material misstatement at the assertion level (see FAM 360.19). [↑](#footnote-ref-44)
44. The term other auditors refers to auditors other than the audit organization performing the entity’s financial statement audit as group auditor. These other auditors may be part of the entity’s monitoring controls. See FAM 630 and 645 for further discussion of using the work of other auditors. [↑](#footnote-ref-45)
45. The auditor may also perform audit procedures on September 30 interim amounts to be included in the consolidated financial statements of the U.S. government for federal entities with different year-ends. [↑](#footnote-ref-46)
46. Firmware is a program or programs recorded in permanent or semipermanent computer memory. [↑](#footnote-ref-47)
47. The FAM uses IDEA as an example of a computer software that the auditor can use to perform certain audit procedures. The auditor may use other software or tools as appropriate in the circumstances. [↑](#footnote-ref-48)