

# Financial Audit Manual

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U.S. GOVERNMENT ACCOUNTABILITY OFFICE



*Council of the*  
**INSPECTORS GENERAL**  
*on INTEGRITY and EFFICIENCY*

June 2018

To Audit Officials, Agency Chief Financial Officers, and Others Interested in Federal Financial Auditing and Reporting

This letter transmits the revised *Financial Audit Manual* (FAM) of the U.S. Government Accountability Office (GAO) and the Council of the Inspectors General on Integrity and Efficiency (CIGIE). The FAM presents a methodology for performing financial statement audits of federal entities in accordance with professional standards and consists of three volumes. FAM Volume 1 contains the audit methodology. FAM Volume 2 provides detailed implementation guidance. FAM Volume 3 contains checklists for Federal Accounting (FAM 2010) and Federal Reporting and Disclosures (FAM 2020). Subsequent to this release, FAM Volume 3 will be updated and distributed periodically.

We have revised the FAM to reflect significant changes in auditing financial statements in the U.S. government since the last major revisions of FAM Volumes 1 and 2 (issued in July 2008) and FAM Volume 3 (issued in August 2007). The revisions to the FAM are primarily based on changes in (1) professional auditing and attestation standards of the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA), (2) GAO's *Government Auditing Standards* (2011), (3) GAO's *Standards for Internal Control in the Federal Government* (2014), and (4) the Office of Management and Budget's audit and reporting guidance.

To help the FAM continue to meet the needs of the federal audit community and the public it serves, GAO and CIGIE worked jointly to update the FAM. In July 2017, CIGIE distributed an exposure draft of FAM Volume 1 for a comment period that ended September 2017. In November 2017, CIGIE distributed an exposure draft of FAM Volume 2 for a comment period that ended in January 2018. In September 2017 (FAM 2010) and October 2017 (FAM 2020), CIGIE distributed an exposure draft of FAM Volume 3 for a comment period that ended in December 2017. All comments we received were considered in the final FAM.

This FAM supersedes previously issued versions of FAM and can be used immediately to audit federal entity financial statements.

Should you need additional information, please contact us at [fam@gao.gov](mailto:fam@gao.gov).



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## Change Log

| Revision # | Date       | FAM Version # | Change Description   | Section Number  | Paragraph                                       |
|------------|------------|---------------|--|---|---|
| N/A        | June 2018  | 1             | New Issuance   |   |   |
| 1          | April 2020 | 1.1           | Aligned GAGAS references to July 2018 revision of the Yellow Book                              | Throughout  | Throughout                                      |
|            |            |               | Changed 'information system controls specialist' to 'information system controls auditor'      | Throughout  | Throughout                                      |
|            |            |               | Removed references to Required Supplementary Stewardship Information                           | Throughout  | Throughout                                      |
|            |            |               | Aligned the representations in the engagement letter with the management representation letter | 215A  | Throughout                                      |
|            |            |               | Added guidance on disclosure entities and public-private partnerships                          | 220, 280, 550   | 220.09 - .10; 280.04; 550.15                    |
|            |            |               | Revised guidance regarding identifying and testing information system controls                 | 220, 240, 270, 290, 295F, 320, 340, 350, 360, 390, 395G | Throughout                                      |
|            |            |               | Added subsection on internal control over financial reporting                                  | 260, 295B   | 260.71; 295B.20                                 |
|            |            |               | Deleted sections regarding multiyear testing of controls                                       | 310, 380, 390, 420, 495F                                | 310.08; 380.01; 390.03; Removed 420.09 and 495F |
|            |            |               | Clarified that segregation of duties is not part of the Presentation and Disclosure assertion  | 395B  | N/A   |
|            |            |               | Clarified that controls should provide only reasonable assurance                               | 395C  | 395C.07 - .10                                   |
|            |            |               | Revised column 8 of the Specific Control Evaluation to also assess implementation              | 395G  | N/A   |

## Financial Audit Manual Volume 1 Change Log

|  |  |           |                                      |
|--|--|-----------|--------------------------------------|
|  | of the internal control activity   |           |                                      |
|  | Removed guidance regarding selecting an attribute sample from a monetary unit sample   | 430, 495E | 430.03; 495E section III, footnote c |
|  | Added guidance regarding cycle summary memos   | 490       | 490.01                               |
|  | Added requirement to evaluate misstatements with the rollover and iron curtain approaches and revised the examples in section 595C   | 540, 595C | 540.05; 595C.03 and examples 1 and 2 |
|  | Revised the conclusion regarding materiality benchmarks in the audit exposure analysis   | 545A      | N/A                                  |
|  | Added guidance for subsequently discovered facts   | 550       | 550.07                               |
|  | Added definitions of 1) cycle, 2) disclosure entities, 3) entity-level controls, 4, information system processing, 5) information technology specialist, 6) iron curtain approach, 7) public-private partnerships, and 8) rollover approach. Revised definitions of 1) accounting application, 2) information system controls auditor, 3) materiality, and 4) related parties. | Glossary  | N/A                                  |

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## **110 – Overview of the FAM Methodology**

- .01 This introduction provides an overview of the methodology of the Government Accountability Office (GAO) and the Council of the Inspectors General on Integrity and Efficiency (CIGIE) for performing financial statement audits of federal entities. It describes how the methodology in the *Financial Audit Manual* (FAM) relates to relevant professional auditing and attestation standards and Office of Management and Budget (OMB) guidance and outlines key issues to be considered in using the methodology.
- .02 The purposes of performing financial statement audits of federal entities include providing decision makers (financial statement users) with assurance as to whether the financial statements are reliable (presented fairly in all material respects, in accordance with U.S. generally accepted accounting principles (U.S. GAAP));<sup>1</sup> reporting deficiencies in internal control over financial reporting or, in certain circumstances, providing an opinion on the effectiveness of internal control over financial reporting, and reporting on noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements (See 245.06 for more information on significant provisions of laws, regulations, contracts, and grant agreements.). To achieve these purposes, the FAM approach to federal financial statement audits involves four phases—Planning, Internal Control, Testing, and Reporting—which are outlined in the rest of this section. In broad terms, the auditor does the following:
- Adequately plans the audit to obtain sufficient appropriate evidence.
  - Understands the design of the entity’s internal control; determines whether the design has been implemented; assesses the risks of material misstatement; designs appropriate tests of controls and substantive procedures; and for the 24 Chief Financial Officers (CFO) Act agencies, determines whether financial management systems comply substantially with the three requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA):
    - federal financial management systems requirements,
    - applicable federal accounting standards, and
    - the *U.S. Government Standard General Ledger* (SGL) at the

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<sup>1</sup>The American Institute of Certified Public Accountants (AICPA) has recognized the Federal Accounting Standards Advisory Board (FASAB) as the accounting standards-setting body for federal government entities under the AICPA’s *Code of Professional Conduct*. Thus, FASAB standards are recognized as U.S. GAAP for federal entities. Statement of Federal Financial Accounting Standards (SFFAS) 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board*, establishes the GAAP hierarchy for federal reporting entities. SFFAS 34 recognizes that it is appropriate for certain federal reporting entities to prepare and publish financial reports pursuant to the accounting and reporting standards issued by the Financial Accounting Standards Board (FASB). SFFAS 34 provides that financial statements prepared in conformity with accounting standards issued by FASB also may be regarded as in conformity with U.S. GAAP for such entities. SFFAS 47, *Reporting Entity*, allows consolidation entities (that is, the consolidated government-wide reporting entity or consolidated component reporting entity) to consolidate component or subcomponent reporting entity financial statements prepared in accordance with FASB under SFFAS 34 without conversion for any differences in accounting policies among the audit organizations.

transaction level.<sup>2</sup>

- Tests the significant assertions related to the financial statements, internal control effectiveness, and compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements (see FAM 235.04 for further details).
- Reports the results of audit procedures performed and performs other audit procedures to complete the audit in accordance with generally accepted government auditing standards (GAGAS).

The FAM audit phases are illustrated in the FAM methodology overview in the contents and are summarized in the following pages of this section.<sup>3</sup>

## Planning Phase

- .03 Although planning continues throughout the audit, the objectives of this phase are to gain an understanding of the entity to be audited; to understand its environment, including internal control; to identify significant areas for audit; and to design effective and efficient audit procedures. To accomplish this, the methodology includes guidance in the following:
- a. Performing preliminary engagement activities relating to (1) acceptance and continuance of client relationships and audit engagements, (2) compliance with relevant ethical requirements, and (3) establishing an understanding of the terms of the engagement with management and, when appropriate, those charged with governance, including establishing that certain preconditions for an audit are present.
  - b. Understanding the entity's operations and its environment, including its organization, management style, internal control, and internal and external factors influencing its operating environment.
  - c. Performing analytical procedures to assist in planning the audit.
  - d. Identifying significant accounting applications, cycles, and financial management systems; relevant budget restrictions; significant provisions of applicable laws, regulations, contracts, and grant agreements; and relevant internal controls.
  - e. Determining the likelihood of effective information system (IS) controls.
  - f. Identifying significant items, accounts, and assertions and using them in planning the audit.
  - g. Determining materiality for the financial statements taken as a whole, including performance materiality, which is the portion of materiality that the auditor allocates to line items, accounts, or classes of transactions.
  - h. Performing a preliminary risk assessment to determine the risk of material misstatement due to error or fraud.

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<sup>2</sup>Testing for substantial compliance with FFMIA's three financial management systems requirements is efficiently accomplished, for the most part, as part of the work done in understanding entity systems in the internal control phase of the audit.

<sup>3</sup>The methodology presented is for a financial statement audit. If the auditor is to use the work of another auditor, see FAM 600 sections.

- i. Establishing the overall audit strategy and developing an audit plan, including entity field locations to visit.

Based on evidence obtained throughout the audit, the auditor should monitor and revise, if needed, preliminary assessments made during the planning phase for risk of material misstatement and the likelihood of control effectiveness. The auditor should revise audit procedures as needed.

## Internal Control Phase

- .04 This phase entails understanding, testing, and assessing internal control over financial reporting to reach conclusions about the achievement of the following internal control objectives:

- 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.
- Compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements—transactions are executed in accordance with significant 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.

- .05 OMB audit guidance requires the auditor to perform sufficient tests of controls that have been suitably designed and implemented to conclude whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). OMB audit guidance does not require the auditor to express an opinion on the effectiveness of internal control.

As required by GAGAS (2018) 6.42, if the auditor does not express an opinion on internal control, the auditor should state in the report whether tests performed provided sufficient, appropriate evidence to express an opinion on the effectiveness of internal control over financial reporting.

GAO auditors<sup>4</sup> should design the audit to express an opinion on internal control over financial reporting.<sup>5</sup> For audits performed by GAO, the internal control testing described in the OMB audit guidance and in the FAM typically

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<sup>4</sup>The FAM refers specifically to objectives for GAO auditors in various sections. Such objectives are optional for other audit organizations.

<sup>5</sup>If the auditor plans to report on internal control effectiveness, AICPA's Clarified Statements on Auditing (AU-C) 940 allows the auditor to give an opinion directly on internal control or on management's assessment about the effectiveness of internal control over financial reporting. However, when internal control is not effective because one or more material weaknesses exist, the auditor is prohibited from expressing an opinion on management's assessment and should report directly on the effectiveness of internal control over financial reporting. The example 1 auditor's report in FAM 595 A illustrates expressing an opinion on internal control directly.

Although the FAM distinguishes between internal control objectives related to reliability of financial reporting and to compliance with laws, regulations, contracts, and grant agreements, compliance controls tested as part of federal financial statement audits are limited to controls over compliance with selected significant provisions of laws, regulations, contracts, and grant agreements applicable to the entity that have a direct effect on the determination of material amounts and disclosures in the entity's financial statements. Consequently, compliance controls in federal financial statement audits are considered to be the equivalent of financial reporting controls for purposes of reporting on control effectiveness.

is sufficient to provide an opinion on internal control effectiveness. Sufficiency and appropriateness of audit evidence is a matter of auditor judgment.

- .06 The FAM also provides guidance on evaluating internal controls related to operating objectives that the auditor **elects** to evaluate. Such controls include those related to safeguarding assets from waste or preparing statistical reports.
- .07 To evaluate internal control, the auditor identifies and understands the relevant controls and tests their effectiveness. Where the auditor determines controls to be effective, the extent of substantive procedures can be reduced.
- .08 The FAM also includes guidance on
  - assessing specific levels of control risk;
  - selecting controls to test;
  - determining the effectiveness of IS controls; and
  - testing controls, including coordinating control tests in the testing phase for efficiency.
- .09 Also, during the internal control phase, in regard to FFMIA, auditors should follow OMB's FFMIA audit guidance,<sup>6</sup> if applicable.

## Testing Phase

- .10 The objectives of this phase are to (1) obtain reasonable assurance about whether the financial statements are presented fairly, in all material respects, in accordance with U.S. GAAP; (2) determine whether the entity complied with significant provisions of applicable laws, regulations, contracts, and grant agreements; and (3) assess the effectiveness of internal control over financial reporting through testing controls often in coordination with other tests.
- .11 To achieve these objectives, the FAM includes guidance on
  - designing and performing substantive, compliance, and control tests;
  - designing and evaluating audit samples;
  - correlating risk of material misstatement, audit risk, and materiality with the nature, timing, and extent of substantive procedures; and
  - designing multipurpose tests that use a common sample to test several different controls, specific accounts or transactions, and audit assertions.

## Reporting Phase

- .12 This phase completes the audit based on the results of audit procedures performed in the preceding phases. This involves developing the auditor's report on the entity's (1) annual financial statements and required supplementary information;<sup>7</sup> (2) internal control over financial reporting; (3) financial

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<sup>6</sup>Office of Management and Budget, "Compliance with the Federal Financial Management Improvement Act of 1996," app. D of *Management's Responsibility for Enterprise Risk Management and Internal Control*, OMB Circular No. A-123, provides guidance on the section 803(a) requirements of FFMIA. App. D can be found at <https://www.whitehouse.gov/>

<sup>7</sup>As defined in OMB reporting guidance, the annual Performance and Accountability Report (PAR) and the Agency Financial Report (AFR) consists of (1) unaudited Management's Discussion & Analysis (MD&A), part of required

management systems' substantial compliance with the three FFMIA requirements (for CFO Act agencies); and (4) compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements. To assist in this process, the FAM includes guidance on forming opinions on the basic financial statements and conclusions on internal control, as well as reporting findings. Also included in FAM 595 A are two examples of auditor's reports. The first example shows when the auditor expresses an opinion on internal control, and the second when the auditor issues a report on internal control.

## Relationship to Applicable Standards

- .13 The following section describes the relationship of the FAM to applicable auditing standards, OMB guidance, and other policy requirements. This section is organized into three areas:
- relevant auditing standards and OMB guidance,
  - audit guidance beyond the *Government Auditing Standards* (also known as GAGAS or the Yellow Book) issued by the Comptroller General of the United States, and
  - auditing standards and policies not addressed in this manual.

## Relevant Auditing Standards and OMB Guidance

- .14 The FAM provides a framework for performing financial statement audits of federal entities in accordance with GAGAS and OMB audit guidance. GAGAS incorporates, by reference, U.S. generally accepted auditing standards (U.S. GAAS) and attestation standards established by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA). The Yellow Book is available at [www.gao.gov](http://www.gao.gov).
- .15 The FAM is an audit methodology that both integrates the requirements of the standards and provides implementation guidance based upon practical experience. The FAM is designed to achieve
- **effective audits** by considering compliance with GAGAS; significant provisions of applicable laws, regulations, contracts and grant agreements; and OMB guidance;
  - **efficient audits** by focusing audit procedures on areas of higher risk and materiality and by providing an integrated approach designed to gather audit evidence efficiently;
  - **quality control** through an agreed-upon framework that is documented and can be followed by all personnel; and
  - **consistency of application** through a documented methodology.

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supplementary information (RSI); (2) audited basic financial statements, including note disclosures; (3) unaudited RSI (other than the MD&A), if applicable; and (4) unaudited other information, if applicable. The audited basic financial statements at an entity level include the (1) balance sheet; (2) statement of net cost; (3) statement of changes in net position; (4) statement of budgetary resources; (5) statement of custodial activity, if applicable; (6) statement of social insurance, if applicable; and (7) statement of changes in social insurance amounts, if applicable. The statements include related audited note disclosures.



- .16 The FAM supplements GAGAS and OMB's audit guidance and includes references to the AICPA's *Clarified Statements on Auditing Standards* (AU-C) and to the related clarified recodified Statements on Standards for Attestation Engagements (AT-C). The AICPA standards are incorporated by reference into GAGAS.

### **Audit Guidance beyond GAGAS**

- .17 In addition to complying with GAGAS, for audits of federal entities to which OMB's audit guidance applies, the auditor should
- perform sufficient tests of internal controls over financial reporting that have been suitably designed and implemented to support a low level of assessed control risk;
  - evaluate and test controls related to budget execution and compliance with selected significant provisions of applicable laws, regulations, contracts, and grant agreements;
  - understand the design of the entity's process for complying with 31 U.S.C. 3512 (c), (d) (commonly known as the Federal Managers' Financial Integrity Act) (FMFIA) and whether the design has been implemented;
  - perform tests to report on the entity's financial management systems' substantial compliance with the three FFMIA requirements, as required by OMB's FFMIA guidance (for CFO Act agencies);
  - test for compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements;
  - read the required supplementary information (RSI), including the Management's Discussion and Analysis (MD&A), for conformity with Federal Accounting Standards Advisory Board (FASAB) standards and OMB reporting guidance; and
  - read the other information for conformity with OMB reporting guidance.
- .18 Auditors may design procedures to consider and report whether misstatements and internal control weaknesses could affect the achievement of operations objectives or the accuracy of reports prepared by the entity.
- .19 GAO auditors generally should design audits to express an opinion on the entity's internal control over financial reporting. When an auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of financial statements, it is referred to as an integrated audit. AU-C 940 addresses integrated audits and certain requirements have been included in the FAM, but auditors should refer to AU-C 940 as needed to provide more detailed guidance.

### **Auditing Standards and Policies Not Addressed in the Manual**

- .20 The FAM supplements financial audit standards and policies adopted by GAO and the inspectors general (IG). It is not intended to address all standards or policies. For example, report processing is not addressed. Further, IGs may use other methodologies that are equivalent to the FAM for conducting financial

statement audits in accordance with GAGAS, including AICPA auditing standards and OMB audit requirements.<sup>8</sup>

- .21 Throughout the FAM, there are references to various laws, regulations, OMB guidance, and other government requirements that are subject to change periodically. Auditors should monitor any changes and ensure that they are using the most updated versions.

## **Key Implementation Considerations**

- .22 In applying the FAM to a federal entity, the auditor considers
- audit objectives;
  - exercise of professional judgment and professional skepticism;
  - form, content, and extent of audit documentation;
  - references to positions;
  - using the work of others;
  - compliance with policies in the FAM;
  - use of technical terms; and
  - reference to sections of the FAM.

These items are discussed in more detail below.

## **Audit Objectives**

- .23 For audits of certain federal entities not subject to OMB audit guidance, the auditor should evaluate whether to conduct those audits in accordance with OMB audit guidance to achieve the audits' objectives. The FAM generally assumes that the objective of the audit is to express an opinion on the current-year financial statements as part of a 2-year opinion on comparative financial statements, to issue a report (or opinion) on internal control over financial reporting, and to issue a report on compliance. When these are not the objectives, the auditor uses judgment in applying the FAM guidance. In some circumstances, the auditor may expect to issue a disclaimer on the current-year financial statements due to scope limitations, including the auditability of information. In these circumstances, the auditor may develop a multiyear plan in order to express a future opinion when the financial statements are expected to become auditable.

## **Exercise of Professional Judgment and Professional Skepticism**

- .24 In performing a financial statement audit, the auditor should exercise professional judgment and professional skepticism in evaluating the quantity and quality of audit evidence, and thus its sufficiency and appropriateness, in determining the audit opinion (AU-C 200.18). Although the auditor may find it necessary to rely on audit evidence that is persuasive rather than conclusive to obtain reasonable assurance, the auditor must not be satisfied with audit

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<sup>8</sup>Under the CFO Act as amended, an IG may perform the agency's financial statements audit with OIG staff or contract the audit to an independent external auditor (IPA firm). See FAM 670, *Oversight of Audits Performed by Contracted IPA Firms*, for details.

evidence that is less than persuasive. The auditor should tailor the guidance in the FAM, if needed, to respond to specific situations encountered during an audit. However, the auditor must, at a minimum, meet professional standards. Proper application of professional judgment and skepticism may result in more extensive audit work than described in the FAM. The auditor should document these decisions.

- .25 The auditor should maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to error or fraud could exist. The auditor's past experience of honesty and integrity of management and those charged with governance does not relieve the auditor of the need to maintain professional skepticism (AU-C 200.17 and 240.12). Professional skepticism includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries (AU-C 200.A24). If the auditor believes that a document may have been altered or is not authentic, then the auditor should investigate further (AU-C 240.13).
- .26 When exercising judgment, particularly when tailoring FAM guidance, the component auditor should consider the needs of, and consult in a timely manner with, the group auditors who plan to use the work being performed so that the judgments exercised can satisfy the needs of both auditors. For example, group auditors of a consolidated entity (such as the U.S. government or an entire department or entity) are likely to plan to use the work of component auditors of subsidiary entities (such as individual departments and entities or bureaus and components of departments). This coordination can result in more effective government audits and avoid duplication of effort.
- .27 Many aspects of a financial statement audit involve technical judgments. The auditor is responsible for making these judgments. The audit organization should have or contract for personnel with adequate technical expertise to provide technical assistance to the auditor, including the following example areas, as necessary:
  - a. quantifying materiality for the financial statements as a whole, performance materiality, and using tolerable misstatement in determining the extent of substantive sampling procedures (see FAM 230);
  - b. identifying risk factors to assess risks of material misstatement (see FAM 260);
  - c. assessing the effectiveness of IS controls (see FAM 270);
  - d. specifying a minimum level of substantive assurance based on the assessed risk of material misstatement, substantive analytical procedures, and substantive detail tests (see FAM 470, 475, 480, and 495D);
  - e. determining whether selections are samples (intended to be representative and projected to populations) or nonsampling selections that are not projectable (see FAM 480);
  - f. using sampling methods, such as monetary unit sampling (MUS), classical variables estimation sampling, or classical probability proportional to size (PPS) sampling, for substantive or multipurpose testing (including nonstatistical sampling) (see FAM 480);

- g. using sampling for control testing, other than attribute sampling, using the tables in FAM 450, to determine sample size when not performing a multipurpose test;
- h. using sampling for compliance testing of significant provisions of applicable laws, regulations, contracts, and grant agreements, other than attribute sampling using the tables in FAM 460, to determine sample size when not performing a multipurpose test; and
- i. placing complete or partial reliance on analytical procedures, using performance materiality to calculate the limit. The limit is the amount of difference between the expected and recorded amounts that can be accepted without further investigation (see FAM 475).

### **Form, Content, and Extent of Audit Documentation**

- .28 Each phase of the FAM methodology includes documentation requirements (see FAM 290, 390, 490, and 590). In addition, the auditor should prepare documentation that ensures the following:
- The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand (a) the nature, timing, and extent of the audit procedures performed to comply with GAGAS; (b) the results of the audit procedures performed and the audit evidence obtained; and (c) significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions (AU-C 230.08).
  - In documenting the nature, timing, and extent of audit procedures performed, the auditor should record (a) the identifying characteristics of the specific items or matters tested, (b) who performed the audit work and the date such work was completed, and (c) who reviewed the audit work performed and the date and extent of such review (AU-C 230.09). For GAO, see Financial Audit Practice Memo #6 (Supplemental Financial Audit Manual Guidance Applicable Only to GAO Engagements) for further information on GAO's policies regarding audit documentation and reviews.
  - The auditor should prepare audit documentation on a timely basis (AU-C 230.07).

### **References to Positions**

- .29 Various sections of the FAM refer to consultation with audit management, persons with the technical expertise to obtain approval or additional guidance, or both. The auditor should document key consultations. Each audit organization should have written evidence, in the audit documentation or in its audit policy manual, of the specific positions of persons who will perform these functions.

The following are references to positions at GAO; however, descriptions of position responsibilities in relation to the audit are included so that the positions or roles can be identified in other audit organizations. IGs performing audits or using firms to perform audits in accordance with the FAM should clarify and

document the positions of the persons that the auditor should consult in various circumstances.

- a. The **audit director** (first partner) is responsible for the quality of the financial statement audit and the audit report, reporting to the assistant IG for the audit or, at GAO, to the managing director.
- b. The **assistant director** is responsible for the operational conduct of the audit and generally for preparation of the audit report. In public accounting firms, the **audit manager** may have these responsibilities.
- c. The **reviewer** (engagement quality control reviewer or second partner) is responsible for providing negative assurance about the quality of the audit and reports to the assistant IG for audit (or higher position) or, at GAO, is the chief accountant or designee. The reviewer may consult with other personnel as needed.
- d. The **audit sampling specialist** is a statistician or other person the auditor consults for technical expertise in areas such as audit sampling, audit sample evaluation, and selecting entity field locations to visit.
- e. The **IS controls auditor** is a person with technical expertise in information systems, general controls, application controls, and information security. This person is involved with the planning, directing, or performing of audit procedures related to IS controls.<sup>9</sup>
- f. The **technical accounting and auditing expert** reports to the assistant IG for audit or higher. At GAO, this is the chief accountant or other designated expert. This expert advises on accounting and auditing professional matters and government-related issues. This person also may be the reviewer or may review reports on financial statements and reports that express opinions on financial information for compliance with professional auditing standards.
- g. The **Office of the General Counsel (OGC)** advises the auditor in (1) identifying significant provisions of applicable laws and regulations to test; (2) identifying budget restrictions; and (3) identifying and resolving legal issues encountered during the financial statement audit, such as evaluating potential instances of noncompliance.<sup>10</sup>
- h. The **Special Investigator Unit** investigates specific allegations involving conflict-of-interest and ethics matters, contract and procurement irregularities, official misconduct and abuse, and fraud in federal programs or activities. In the offices of the IGs, this is the investigation unit; at GAO, it is the Forensic Audits and Investigative Service team. The Special Investigator Unit provides assistance to the auditor by (1) informing the auditor of relevant pending or completed investigations of the entity and (2) investigating possible instances of fraud, waste, and abuse.

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<sup>9</sup>App. V of GAO's Federal Information System Controls Audit Manual (FISCAM) provides examples of the knowledge, skills, and abilities that an IS controls auditor should possess.

<sup>10</sup>Audit organizations obtain legal counsel in a variety of ways, and each audit organization's OGC size and configuration can vary. In that regard, the designation of OGC in the FAM could include legal counsel in IG offices that employ or hire their own legal counsel as well as the entity's legal counsel.

## **Using the Work of Others**

- .30 The auditor should consider whether specialized skills are needed to perform 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 sections in 600 for guidance in using the work of others.

## **Compliance with Policies in the FAM**

- .31 The following terms are used throughout the FAM (all volumes) to describe the degree of compliance with the standard or policy:
- **Must:** Compliance is mandatory when the circumstances exist to which the requirement is relevant. Most "musts" indicate unconditional requirements that come directly from professional auditing standards while other instances of "must" are unique needs for the government environment and, therefore, determined by GAO/CIGIE to be required.
  - **Should:** Compliance is mandatory when the circumstances exist to which the requirement is relevant, except in rare circumstances when the specific procedure to be performed would be ineffective in achieving the intent of the requirement (AU-C 200.26). The auditor must document (1) the justification for any departure and (2) how the alternative audit procedures performed were sufficient to achieve the intent of the requirement or policy (AU-C 230.13). The documentation should be approved by the reviewer.<sup>11</sup>
  - **Generally should:** Compliance is strongly encouraged when the circumstances exist to which this policy is relevant. The auditor should discuss any departure with the assistant director (or equivalent, such as the audit manager in a public accounting firm) and document such discussions.
  - **May, might, could:** These terms are used in the FAM to provide further explanation of and guidance for implementing audit requirements. Compliance is optional. The auditor need not document compliance.

## **Use of Technical Terms**

- .32 The FAM uses many existing technical auditing terms and includes a glossary of significant terms at the end of volume I.

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<sup>11</sup>Similar to the AICPA auditing standards, if the FAM states that a procedure or action is one that the auditor "should consider," determining whether to perform the procedure or action is required; however, performing the procedure or action is not. Because this is a "should," the auditor should document any reasons for **not** performing this procedure and the alternative procedures performed to meet the objective. When the FAM lists factors that the auditor should evaluate when making a judgment, the auditor is expected to use these factors to make an informed judgment. However, the auditor may also consider other factors.

### **Reference to Sections of the FAM**

- .33 When cited in audit documentation, correspondence, or other communication, “FAM” may precede section or paragraph numbers. For example, this paragraph is referred to as FAM 110.33.

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# SECTION 200

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Planning Phase



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## **210 – Overview of the Planning Phase**

- .01 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 federal entity's financial statements; internal controls; and compliance with applicable laws, regulations, contracts, and grant agreements. 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.
- 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.
- .02 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 audit team (AU-C 300.A4).
- .03 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).
- .04 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. See FAM 620 for guidance on the auditor's use of the work of specialists in an audit (AU-C 300.12). 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 220.16).
- .05 The auditor should plan the nature, timing, and extent of direction and supervision of audit team members and review of their work. The nature, timing, and extent of the direction and supervision of the audit 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 assessed 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.A16).

- .06 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**

- .01 The auditor should undertake the following activities at the beginning of the audit (AU-C 300.06 and AU-C 300.13).
- Perform procedures regarding the acceptance and continuance of client relationships and audit engagements as required by AU-C 220.
  - Evaluate auditor’s compliance with relevant ethical requirements in accordance with AU-C 220 and *Government Auditing Standards* Chapter 1, “Government Auditing: Foundation and Ethical Principles.”
  - Establish an understanding of the terms of the engagement with management<sup>1</sup> and, when appropriate, those charged with governance,<sup>2</sup> including establishing that certain preconditions for an audit are present, as required by AU-C 210.

- .02 In the federal environment, the “client” may include the
- management of the federal entity to be audited, including senior executive and financial managers;
  - inspector general (IG) if the IG has contracted for the audit;
  - members of a board or commission responsible for the federal entity; and/or
  - audit committee.

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 215.25 for additional guidance on identifying those charged with governance.

- .03 For most federal 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 550.16 in the communication to the

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<sup>1</sup>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.

<sup>2</sup>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. 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, 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.

- Congress or its committees, but the auditor is not required to communicate these items.
- .04 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).
- .05 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**

- .06 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 220.14). These procedures are established by the auditing organization 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 220.14). The following information assists the engagement partner in making this determination (AU-C 220.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).
  - Significant findings or issues that have arisen during the current or previous audit engagement and their implications for continuing the relationship.
- .07 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 220.09). 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 220.11). 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 220.12).

- .08 The engagement partner should form a conclusion on compliance with independence requirements that apply to the audit engagement by
- 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;
  - 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
  - taking appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards or, if considered appropriate, to withdraw from the audit engagement when withdrawal is possible. The engagement partner should promptly report to the audit organizations any inability to resolve the matter so that the organization may take appropriate action. (AU-C 220.13 and GAGAS (2018) 3.27)
- .09 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 220.A8).
- .10 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).
- .11 For an initial audit engagement or reaudit engagement (financial statements previously audited by a predecessor auditor), the auditor should request management, or the organization that contracted the previous year's audit (i.e., engaging party), to 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 or limits the response, the auditor should inquire of the reasons and consider the implications in deciding whether to accept the engagement. The auditor should also evaluate the predecessor auditor's response, or consider the implications of no response or a limited response, in determining whether to accept the engagement (AU-C 210.11 through .12).

- .12 The communication with the predecessor auditor may be either written or oral. Matters subject to the auditor's inquiry of the predecessor auditor may include the following:
- information that might bear on the integrity of management;
  - disagreements with management about accounting policies, auditing procedures, or other similarly significant matters;
  - communications to those charged with governance regarding fraud and noncompliance with laws, regulations, contracts, and grant agreements by the entity;
  - communications to management and those charged with governance regarding significant deficiencies and material weaknesses in internal control; and
  - the predecessor auditor's understanding about the reasons for the change of auditors. (AU-C 210.A31)
- .13 The auditor should document the following related to acceptance and continuance of clients and audit engagements and relevant ethical requirements:
- conclusions reached regarding acceptance and continuance of the client relationship and audit engagement;
  - any issues identified with respect to compliance with relevant ethical requirements and how they were resolved, including 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. (AU-C 220.25 and GAGAS (2018) 3.107)

## **Preconditions for an Audit**

- .14 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 provides the criteria for management to present the financial statements of an entity, including the fair presentation of those financial statements (e.g., U.S. GAAP) (AU-C 210.A2). The Federal Accounting Standards Advisory Board (FASAB) is the body designated by the AICPA as the source of 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 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:

- 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)
- Whether law or regulation prescribes the applicable financial reporting framework (AU-C 210.A4).

- .15 Additionally, the auditor should obtain the agreement of management that it acknowledges and understands its responsibilities in a financial statement audit, including responsibility for (1) the preparation and fair presentation of the financial statements in accordance with U.S. GAAP (or other applicable financial reporting framework); (2) 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; and (3) complying 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 (1) 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; (2) additional information that the auditor may request from management for the purpose of the audit; and (3) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence (AU-C 210.06b and .A42). The example audit engagement letters in FAM 215 A include these and other management responsibilities for an audit of a federal entity.
- .16 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 .A42). This agreement should generally be obtained from the same officials whom the auditor will request sign the management representation letter.
- .17 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 Chief Financial Officers (CFO) Act, the Government Management Reform Act (GMRA), or the Accountability of Tax Dollars Act (ATDA), while government corporations are required to prepare audited financial statements under the Government Corporations Control Act.



## **Agreement on the Terms of the Engagement**

- .18 The auditor should agree upon the terms of the engagement with management and, when appropriate, those charged with governance. 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 the required elements and wording in AU-C 210.10, related to the objectives and scope; the responsibilities of both federal entity management and the auditor; 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; identification of the applicable financial reporting framework for the preparation of the financial statements (e.g., U.S. GAAP); and 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, 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. An example audit engagement letter to a federal entity is presented at FAM 215 A.
- .19 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.
- .20 The engagement letter or written agreement should include the auditor's responsibility for (1) testing and reporting on compliance with 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 FFMIA requirements (for CFO Act agencies); and (3) applying certain limited procedures to any RSI, and reading other information, and reporting the results.
- .21 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.
- .22 The engagement letter or written agreement is designed to avoid misunderstandings between the federal 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.

- .23 The engagement letter or written agreement should provide that if management of the federal 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. The auditor should promptly inform the party contracting for the audit.

## **Communicating with Those Charged with Governance**

- .24 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).
- .25 The auditor should determine the appropriate persons within the entity's governance structure with whom to communicate. The appropriate persons may vary depending on the matter to be communicated. 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. 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 260.07 and .A8).
- .26 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.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 .08, .09, .A10, and .A11).
- .27 The auditor should communicate to those charged with governance (1) the auditor's responsibilities under GAGAS (see FAM 215.28 through .29); (2) an overview of the planned scope and timing of the audit (see FAM 215.30); (3) the nature of planned work and level of assurance provided related to internal control over financial reporting and compliance with 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, and .15). [Note: GAO auditors should use the engagement letter.]

- .28 The auditor should communicate with those charged with governance the auditor's responsibilities under GAGAS, including that
- 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 presented fairly, in all material respects, in conformity with U.S. GAAP, and
  - the audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

If the entity includes other information in documents containing audited financial statements, such as in a PAR, the auditor should communicate with those charged with governance the auditor's responsibility with respect to such other information, any procedures performed relating to the other information, and the results (AU-C 260.10 and AU-C 720.08).

- .29 The auditor may also communicate to those charged with governance the auditor's responsibilities 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 215.24 (AU-C 260.A13).
- .30 The auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit. 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.A18 through .A22 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 (AU-C 260.11 and .A18 through .A22).
- .31 The auditor should communicate significant findings and issues from the audit to those charged with governance, as discussed in FAM 550.16 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.A39 through .A41 (AU-C 260.12, .13, .14, and .16 and .A39 through .A41).
- .32 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).
- .33 The auditor's clear communication of these matters helps establish the basis for effective two-way communication. Other discussion topics that may contribute to

the effectiveness of two-way communication are included in AU-C 260.A35. As discussed in FAM 550.18, 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 260.19 and .A34 through .A36).

- .34 When matters in AU-C 260 discussed above for government entities 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). For audits of nongovernment entities, see AU-C 260.17.
- .35 The auditor should communicate with those charged with governance on a timely basis. AU-C 260.A42 through .A43 discuss factors relevant for making judgments regarding the timing of these communications (AU-C 260.18, .A42, and .A43).
- .36 The auditor should document all 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 (AU-C 260.20).

### **Intent, Notification, and Commitment Letters**

- .37 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.
- .38 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 federal 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.
- .39 A notification letter is used by some auditors to notify federal 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.
- .40 A commitment letter is used by some auditors, either after a survey of work or the planning phase has been completed, as discussed in FAM 215.37, 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.
- .41 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 to a Federal Entity**

- .01 As discussed in FAM 215.18, the engagement letter documents the objectives and scope, the roles and responsibilities of both federal entity 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. These sample letters are prepared on auditor letterhead and modified for the specific circumstances of each individual audit, as needed.

## 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 [20XX], the financial statements of the [full name of the federal 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 fairly presented, in all material respects, in accordance with U.S. generally accepted accounting principles.
2. Express an opinion on whether the [entity] maintained, in all material respects, effective internal control over financial reporting as of [fiscal year-end date] based on the criteria established under 31 U.S.C. § 3512 (c), (d), commonly known as the Federal Managers’ Financial Integrity Act (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 [20XX].
4. Report whether [entity’s] financial management systems comply substantially with the three requirements of the Federal Financial Management Improvement Act (FFMIA) as of [fiscal year-end date]. [If applicable.]

Upon completion of our audit, we will issue a written report consistent with these objectives. We cannot provide assurance that an unmodified opinion on the financial statements or on the effectiveness of internal control over financial reporting [or on financial management systems’ substantial compliance with FFMIA requirements, if applicable] will be expressed. Circumstances may arise in which it is necessary for us to modify our opinions or add emphasis-of-matter or other-matter paragraphs.

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 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 one of the previous two paragraphs, as shown, based on the planned scope of the FFMIA work and reporting, if applicable.]<sup>1</sup>**

### **Management's Responsibilities**

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

1. the preparation and fair presentation of the **[entity's]** financial statements, including accompanying notes, in accordance with U.S. generally accepted accounting principles **[or other applicable financial reporting framework]**;
2. maintaining effective internal control over financial reporting for the **[entity]**. This includes 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;
3. evaluating the effectiveness of the **[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 **[fiscal year-end date]**. 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 on the effectiveness of **[entity's]** internal control over financial reporting;
5. supporting its assessment about the effectiveness of the **[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 U.S. generally accepted accounting principles;
8. preparing and presenting other information included in documents containing the audited financial statements and auditor's report, and ensuring the consistency of that information with the audited financial statements and RSI;
9. designing, implementing, and maintaining 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; and
11. ensuring that the **[entity's]** financial management systems comply substantially with FFMIA requirements **[if applicable]**.

In addition, **[entity's]** management acknowledges and understands that it has the responsibility to provide us with

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<sup>1</sup>Modify the opinion paragraph as shown if the objective is to express an opinion on the systems' substantial compliance with FFMIA. Non-GAO auditors who do not express an opinion on compliance should modify the compliance report paragraph as shown if the objective is to report on the results of the FFMIA compliance tests without expressing an opinion.



1. 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;
2. additional information that we may request from management for the purpose of the audit including, but not limited to
  - a. 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
  - b. any communications from the Office of Management and Budget (OMB) and 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. all 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 **[20xx]** or prior fiscal year's financial statements;
2. all deficiencies in the design or operation of internal control over financial reporting as of **[fiscal year-end date]**, including separately identifying any deficiencies management believes to be significant deficiencies or material weaknesses;<sup>2</sup>
3. a description of fraud or suspected fraud that affects the **[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 events occurring or facts discovered subsequent to the date of the financial statements, of which management may become aware, that may affect the financial statements;
5. whether, subsequent to the date being reported on, there were any changes in internal control or other factors that might significantly affect internal control, including any corrective actions taken by management with regard to material weaknesses and significant deficiencies; and
6. 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 to us prior to issuance.

As part of our audit process, we will require from **[entity]** management written confirmation concerning representations made to us in connection with the audit of the

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<sup>2</sup>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, 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.

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 which 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 **[and OMB audit guidance, if applicable]**. Those standards require that we plan and perform the audits to obtain reasonable, rather than absolute, assurance about (1) whether the financial statements are free from material misstatement and (2) whether effective internal control over financial reporting was maintained in all material respects.

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the auditor's assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of financial statements also involves evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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.

An audit of internal control over financial reporting involves performing procedures to obtain evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risk that a material weakness exists. An audit of internal control over financial reporting also includes obtaining an understanding of internal control over financial reporting, and evaluating

and testing the design and operating effectiveness of internal control over financial reporting based on the assessed risk. Our audit of internal control also will consider **[entity]**'s process for evaluating and reporting on internal control over financial reporting based on criteria established under FMFIA **[or other appropriate criteria]**. Our audits will include performing such other procedures that we consider necessary in the circumstances.

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 the effectiveness of internal control over financial reporting was maintained, in all material respects, as of **[fiscal year-end date]**. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness.

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 consider not 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.<sup>3</sup> 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 whether **[entity's]** financial management systems comply substantially with the three FFMA requirements **[if applicable]** and (2) applying certain limited procedures to any required supplementary information and required supplementary stewardship information **[if applicable]**, and reading other information included with the financial statements in a document containing our auditor's report.

#### **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. This assistance may include preparing schedules or analyses; locating, copying, and providing selected documents; and participating in meetings. We will need draft financial statements and any other information to be included in the document containing our auditor's 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

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<sup>3</sup>If applicable, include sentence to add tests of laws and regulations listed in OMB audit guidance that we deem applicable to the financial statements.

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 **[20XX]** 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 yours,

**[Auditor's name and title]**

cc: CFO of **[federal entity]**  
Inspector General of **[federal 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 terms and arrangements described above for the audit of **[entity]**’s financial statements, including our respective responsibilities, and the scope of work and related reporting on (1) the financial statements; (2) internal control over financial reporting; (3) compliance with laws, regulations, contracts, and grant agreements applicable to **[entity]**; (4) financial management systems’ substantial compliance with FFMIA requirements **[omit if not applicable]**; (5) the required supplementary information **[omit if not applicable]**; (6) the required supplementary stewardship information **[omit if not applicable]**; and (7) other information to be included in the document containing the auditor’s report and financial statements **[omit if not applicable]**.

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Signature

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Date

**[Name and Title]**

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Signature

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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 [20XX], the financial statements of the [full name of the federal 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 fairly presented, in all material respects, in accordance with U.S. generally accepted accounting principles.
2. Report any significant deficiencies and material weaknesses<sup>1</sup> in internal control over financial reporting for fiscal year [20XX] that come to our attention as a result of the audit.
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 [20XX].
4. Report whether [entity’s] financial management systems comply substantially with the requirements of the Federal Financial Management Improvement Act (FFMIA) as of [fiscal year-end date]. [If applicable.]

Upon completion of our audit, we will issue a written report consistent with these objectives. We cannot provide assurance that an unmodified opinion on the financial statements [or on financial management systems’ substantial compliance with FFMIA requirements, if applicable] will be expressed. Circumstances may arise in which it is necessary for us to modify our opinions or add emphasis-of-matter or other-matter paragraphs.

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 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

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<sup>1</sup>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.

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 one of the previous two paragraphs, as shown, based on the planned scope of the FFMIA work and reporting, if applicable.]<sup>2</sup>**

### **Management's Responsibilities**

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

1. the preparation and fair presentation of the **[entity's]** financial statements, including accompanying notes, in accordance with U.S. generally accepted accounting principles **[or other applicable financial reporting framework]**;
2. maintaining effective internal control over financial reporting for the **[entity]**. This includes 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;
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 U.S. generally accepted accounting principles;
5. preparing and presenting other information included in documents containing the audited financial statements and auditor's report, and ensuring the consistency of that information with the audited financial statements and RSI;
6. designing, implementing, and maintaining 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; and
8. ensuring that the **[entity's]** financial management systems comply substantially with FFMIA requirements **[if applicable]**.

In addition, **[entity]**'s management acknowledges and understands that it has the responsibility to provide us with

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<sup>2</sup>Modify the opinion paragraph as shown if the objective is to express an opinion on the systems' substantial compliance with FFMIA. Non-GAO auditors who do not express an opinion on compliance should modify the compliance report paragraph as shown if the objective is to report on the results of the FFMIA compliance tests without expressing an opinion.

1. 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;
2. additional information that we may request from management for the purpose of the audit including, but not limited to:
  - a. 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
  - b. any communications from the Office of Management and Budget (OMB) and 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. all 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 **[20XX]** or prior fiscal year's financial statements;
  2. all deficiencies in the design or operation of internal control over financial reporting as of **[fiscal year-end date]**, including separately identifying any deficiencies management believes to be significant deficiencies or material weaknesses;
  3. a description of fraud or suspected fraud that affects the **[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 events occurring or facts discovered subsequent to the date of the financial statements, of which management may become aware, that may affect the financial statements;
  5. whether, subsequent to the date being reported on, there were any changes in internal control or other factors that might significantly affect internal control, including any corrective actions taken by management with regard to material weaknesses and significant deficiencies; and
- 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 to us prior to issuance.

As part of our audit process, we will require 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 which 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, rather than absolute, assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the auditor's assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also involves evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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.

In making our risk assessments, we will consider internal control relevant to the preparation and fair presentation of the financial statements 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 over financial reporting. As such, we will not express an opinion on internal control. In addition, we will not consider 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. Our internal control work will not necessarily identify all deficiencies in internal control, including those that might be material weaknesses or significant deficiencies.

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. If we identify deficiencies in **[entity]**'s internal control that we consider not 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.<sup>3</sup> 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 whether **[entity]**'s financial management systems comply substantially with the three FFMIA requirements **[if applicable]** and (2) applying certain limited procedures to any required supplementary information and required supplementary stewardship information **[if applicable]**, and reading other information included with the financial statements in a document containing our auditor's report.

#### **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. This assistance may include preparing schedules or analyses; locating, copying, and providing selected documents; and participating in meetings. We will need draft financial statements and any other information to be included in the document containing our auditor's 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 **[20XX]** 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.

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<sup>3</sup>If applicable, include sentence to add tests of laws and regulations listed in OMB audit guidance that we deem applicable to the financial statements.

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 yours,

**[Auditor's name and title]**

cc: CFO of **[federal entity]**  
Inspector General of **[federal 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 terms and arrangements described above for the audit of **[entity]**’s financial statements, including our respective responsibilities, and the scope of work and related reporting on (1) the financial statements; (2) internal control over financial reporting; (3) compliance with laws, regulations, contracts, and grant agreements applicable to **[entity]**; (4) financial management systems’ substantial compliance with FFMIA requirements **[omit if not applicable]**; (5) the required supplementary information **[omit if not applicable]**; (6) the required supplementary stewardship information **[omit if not applicable]**; and (7) other information to be included in the document containing the auditor’s report and financial statements **[omit if not applicable]**.

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Signature

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Date

**[Name and Title]**

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Signature

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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 federal 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 20XX financial statements of the **[name of federal entity]**. We **[held or will hold]** an entrance conference with officials of the **[entity]** on **[date]**.

**[If mandated:]** We are responsible for conducting audits of the financial statements of the **[federal 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 the **[federal entity]**. **[If auditor's statutory authority:]** Under our audit authority **[cite legal or contract authority]**, we will conduct an audit of financial statements of the **[federal entity]**. We plan to issue our report by **[date]**.

A copy of our **[date]** audit engagement letter to the **[entity or inspector general]** is attached.<sup>1</sup> 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 the **[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 yours,

**[Auditor name and title]**

Enclosure

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<sup>1</sup>Sample engagement letter to a federal entity or inspector general from FAM 215 A.

## **220 – Understand the Entity's Operations**

- .01 The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. In planning the audit, the auditor gathers information to obtain an overall understanding of the entity, including its origin and history, size and location, organization, mission, business, strategies, inherent risks, fraud risks, control environment, risk assessment from both internal and external sources, information and communication, and monitoring.

Understanding the entity's operations in the planning process enables the auditor to identify and respond to risks of material misstatement at the assertion level and to resolve accounting and auditing problems early in the audit. Based on an appropriate understanding of the entity and its environment, including its internal control, the auditor should assess the risks of material misstatement at the financial statement and relevant assertion levels as discussed in the planning and internal control phases of the FAM and then should respond to those identified risks when designing the nature, extent, and timing of further audit procedures to be performed in the internal control and testing phases of the audit.

- .02 The auditor should obtain an understanding of the entity and its environment that in the auditor's judgment, is sufficient to meet the objective in FAM 220.01, including (AU-C 315.12 and 315.A3)
- a. the nature of the entity;
  - b. the legal and regulatory framework applicable to the entity and how the entity is complying with the framework (AU-C 250.12.a);
  - c. the financial reporting framework (U.S. GAAP) applicable to the entity, including the use of accounting estimates and the entity's related party relationships and transactions (AU-C 315.12a, 540.08, and 550.14 through .15);<sup>1</sup>
  - d. the identification and assessment of the risks of material misstatement for accounting estimates and the entity's related party relationships and transactions (see FAM 220.07 and 220.08 below) (AU-C 540.08 and 550.12);
  - e. external factors affecting operations, including any industry factors (AU-C 315.12.a);

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<sup>1</sup>Related party relationships and transactions include personal and financial relationships between entity officials and nonfederal entities, such as contractors. Such related party relationships and transactions may include, as defined by FASAB, disclosure entities, related parties, and public-private partnerships (FAM 904.03). Relationships and transactions between the entity and other federal entities (intragovernmental) are not considered related party relationships and transactions.

- f. internal factors affecting operations, including the entity's objectives and strategies and those related business risks that may result in risks of material misstatement (AU-C 315.12.d);
- g. measurement and review of the entity's financial performance (AU-C 315.12.e); and
- h. accounting policies. The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor should evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry (AU-C 315.12.c).

Additional guidance on obtaining an understanding of these areas is included in AU-C 315, Appendix A, and AU-C 315.A18 through .A41.

- .03 As part of understanding the entity and its environment, the auditor should obtain an understanding of the design of internal controls that are relevant to the audit and determine whether they have been implemented. Internal control relevant to the audit includes the design of each of the components of internal control (control environment, entity risk assessment, information and communication, control activities, and monitoring). See FAM 260.
- .04 The auditor should obtain an understanding of the nature 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), including use of service organizations (see FAM 310.11 and FAM 640 for further details on service organizations);
  - the way that the entity is structured and how it is financed, to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements (AU-C 315.12.b.iv);
  - key members of management; and
  - the complexity of operations.
- .05 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/or grant agreement claims. (AU-C 250.12 and .A8)
- .06 The auditor should obtain an understanding of the applicable U.S. GAAP, including accounting principles and industry-specific practices (AU-C 315.A20). For accounting estimates and related party relationships and transactions, the auditor should obtain an understanding of the items discussed in FAM 220.07 through .08.
- .07 For accounting estimates, the auditor should obtain an understanding of the following (AU-C 540.08).
- The requirements of the applicable U.S. GAAP relevant to accounting estimates, including related disclosures.
  - How management identifies those transactions, events, and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor should make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
  - How management makes the accounting estimates and the data on which they are based, including
    - the method(s) and model, if applicable, used in making the accounting estimate;
    - relevant controls;
    - whether management has used a specialist;
    - the assumptions underlying the accounting estimates;
    - whether there has been or ought to have been a change from the prior period in the method(s) or assumption(s) for making the accounting estimates and, if so, why; and
    - whether and, if so, how management has assessed the effect of estimation uncertainty.
- Additional requirements for accounting estimates are discussed in FAM 260 relating to risk assessment procedures and FAM 905 relating to substantive testing.
- .08 For related party relationships and transactions, the auditor should inquire of management to obtain an understanding of the following (AU-C 550.14).<sup>2</sup>
- The identity of the entity's related parties, including changes from the prior period.
  - The nature of the relationships between the entity and these related parties.

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<sup>2</sup>Related party relationships and transactions may include, as defined by FASAB, disclosure entities, related parties, and public-private partnerships (FAM 904.03).



- Whether the entity entered into any transactions with these related parties during the period and, if so, the types and purposes of the transactions.

Additionally, through inquiry of management and others within the entity, observation, and inspection, the auditor should obtain an understanding of the relevant controls, if any, that management has established to

- identify, account for, and disclose related party relationships and transactions;
- authorize and approve significant transactions and arrangements with related parties; and
- authorize and approve significant transactions and arrangements outside the normal course of business. (AU-C 550.15)

Additional requirements for related parties are discussed in FAM 260 relating to risk assessment procedures, FAM 280 relating to sharing of information and maintaining alertness, FAM 904 relating to substantive testing, and FAM 550 relating to conclusions.

- .09 Related party relationships may include disclosure entities, for which the auditor should inquire of management to obtain an understanding of the following.

- The identity of the entity's disclosure entities, including changes from the prior period.
- The nature of the relationships between the entity and these disclosure entities.
- The nature and magnitude of relevant activity with these disclosure entities during the period.
- The 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.

Additionally, through inquiry of management and others within the entity, observation, and inspection, the auditor should obtain an understanding of the relevant controls, if any, that management has established to identify, account for, and disclose disclosure entity transactions and whether they have been implemented.

The auditor should consider disclosure entities when assessing additional requirements for related parties, as discussed in FAM 260 relating to risk assessment procedures, FAM 280 relating to sharing of information and maintaining alertness, and FAM 550 relating to conclusions.

- .10 Related party relationships may also include public-private partnerships, for which the auditor should inquire of management to obtain an understanding of the following.

- 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.
- The entity's statutory authority for entering into the public-private partnership.

- The source and amounts of the funding of the public-private partnership over its expected life.
- The operational and financial structure of the public-private partnership, including the entity's rights and responsibilities.
- The contractual risks of loss the entity is undertaking within the public-private partnership.

Additionally, through inquiry of management and others within the entity, observation, and inspection, the auditor should obtain an understanding of the relevant controls, if any, that management has established to identify, account for, and disclose public-private partnership transactions and whether they have been implemented.

The auditor should consider public-private partnerships when assessing additional requirements for related parties, as discussed in FAM 260 relating to risk assessment procedures, FAM 280 relating to sharing of information and maintaining alertness, and FAM 550 relating to conclusions.

- .11 The auditor should identify significant external and internal factors that affect the entity's operations as part of understanding the entity and its environment for purposes of planning the audit. External factors include

- source(s) of funds;
- seasonal fluctuations;
- current political climate; and
- other external factors, such as general economic conditions, interest rates, and inflation. (AU-C 315.A22)

Internal factors 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.

- .12 The auditor should obtain an understanding of

- the entity's selection and application of accounting policies and whether they are appropriate for its activities and consistent with U.S. GAAP, including changes in U.S. GAAP that affect the entity, and
- whether entity management appears to follow aggressive or conservative accounting policies.

The auditor should also identify financial reporting standards that are new to the entity and understand when and how the entity will adopt such standards. Where the entity has changed its selection of or method of applying a significant accounting policy, the auditor should evaluate the reasons for the change and whether it is appropriate and consistent with U.S. GAAP.

- .13 The auditor also 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;
  - stewardship investments for nonfederal physical property, human capital, and research and development; and
  - social insurance programs.
- .14 The auditor should develop and document a high-level understanding of the entity's use of information systems and how these systems affect the generation of financial statement and RSI in the annual PAR or AFR. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity's use of information systems and in planning, directing, or performing audit procedures related to assessing IS controls. The *Federal Information System Controls Audit Manual* (FISCAM) may be used to develop this understanding and assess IS controls. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls.
- .15 The auditor may gather planning information through different methods (observation, 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.
- .16 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;
  - FMFIA<sup>3</sup> reports and supporting documentation;
  - reports by management or the auditor about financial management systems' substantial compliance with the three FFMIA requirements (for CFO Act agencies only);

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<sup>3</sup>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 595A.

- 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);
- congressional hearings and reports;
- consultants' reports; and
- material published about the entity in newspapers, magazines, Internet sites, and other publications.

.17 Audit documentation from prior-year audits may contain useful information for planning the current-year audit. The auditor should determine whether changes have occurred since the previous audit that may affect its relevance to the current audit (AU-C 315.10). 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**

- .01 As part of the risk assessment procedures, the auditor should perform preliminary analytical procedures (AU-C 315.06b) to
- understand the entity’s business, including current-year transactions and events;
  - identify account balances, transactions, ratios, or trends that may signal risks of material misstatement, including any risks related to fraud (see FAM 260); and
  - determine the nature, extent, and timing of further audit procedures to be performed.
- .02 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.
- .03 The auditor generally should perform the following steps to achieve the objectives of preliminary analytical procedures:
- a. **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, counter to the auditor’s expectations, 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 due to an error or possible 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.
- b. **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 due to errors or omissions in unaudited comparative data.

A key to effective preliminary analytical procedures is to use 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.

- c. **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."

- d. **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 the existence of risk of material misstatement due to control, fraud, or inherent risk.

- .04 The auditor should consider the results of preliminary analytical procedures in assessing the risks of material misstatement due to error or fraud (see FAM 260).

## **230 – Determine Materiality**

- .01 Materiality is one of several factors the auditor uses to determine the nature, extent, and timing of procedures. Materiality represents the magnitude of an omission or misstatement of an item, or an aggregation of items, in the financial statements that in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item. When establishing the overall audit strategy, the auditor should determine materiality for the financial statements as a whole (AU-C 320.10).
- .02 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. Even though quantitatively immaterial, certain misstatements or omissions, could be qualitatively material.
- .03 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.
- .04 U.S. GAAS as incorporated in GAGAS indicate 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 in forming the opinion in the auditor's report (AU-C 320.05). Materiality is a matter of professional judgment and is affected by the auditor's perception of the needs of financial statement users. Materiality judgments are made in light of surrounding circumstances and 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.
- .05 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 taken as a whole** is based on professional judgment and is a preliminary estimate in relation to the financial statements taken 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 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 particular line items, accounts, classes of transactions (such as disbursements), or disclosures. 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). The auditor usually sets this amount the same for all line items or accounts as this amount is usually sufficient for testing (except for specific circumstances, and certain intragovernmental or offsetting balances, as discussed in FAM 230.10).

- **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 or accounts 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. Matters 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). The clearly trivial amount set by the auditor should be substantially below tolerable misstatement so that the aggregate of many items at the clearly trivial amount would not exceed tolerable misstatement.

.06 The FAM also uses the term "materiality" in the reporting phase.

- **FMFIA materiality** is the threshold established by management for determining whether a matter meets OMB criteria for reporting matters under FMFIA as described in FAM 580.47 through .49.
- **Management Representation Letter materiality**: See FAM 1001.07.
- **Legal Letter materiality**: See FAM 1002.17 through .20.

.07 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 audit director should discuss the basis for the determination with the reviewer. The auditor should document materiality and the method of determining materiality. The audit director should review and approve the documentation.

.08 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). If, in the specific circumstances of the entity, one or more particular classes of transactions, account balances, or disclosures exist for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users, then, taken on the basis of the financial statements, the auditor also should determine the materiality level or levels to be applied to those particular classes of transactions, account balances, or disclosures (AU-C 320.10). 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 classes of transactions, account balances, or disclosures) 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 classes of transactions, account balances, or disclosures) 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).

- .09 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 (net of adjustments for intragovernmental balances and offsetting balances). (See the 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 under auditing. 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 over auditing 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.

- .10 In determining the materiality benchmark, the auditor should decide how to handle significant intragovernmental balances (such as funds with the U.S. Treasury, U.S. 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) due to 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 federal 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.

- .11 The auditor generally should set materiality at 3 percent of the materiality benchmark. Although the auditor may use a mechanical means to compute materiality, the auditor should use judgment in evaluating whether the computed 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 not reflected in the materiality benchmark, but that may be important to the financial statement user.
- .12 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 or accounts to allow the auditor to detect an aggregate material misstatement in the financial statements, as discussed in FAM 260.04. See FAM 545.02 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 class of transactions, account balance, or disclosure.
- .13 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 and assertions (which increases the extent of testing), particularly when
- the population from which the sample is selected approximates or is lower than the line item or account balance being tested or
  - the area tested is sensitive to the financial statement users or may be qualitatively material.

## **235 – Identify Significant Line Items, Accounts, and Assertions**

- .01 The auditor should identify significant line items and accounts in the financial statements and significant related financial statement assertions. These line items and accounts include budget-related information, such as that presented in the statement of budgetary resources; the reconciliation of the net cost of operations to budget note disclosure; and disclosure of the components of net position. The auditor should perform appropriate control and substantive tests for each significant assertion for each significant line item and account. By identifying significant line items, accounts, and the related assertions early in the planning process, the auditor is more likely to design effective and efficient audit procedures. Some insignificant line items, accounts, and assertions may not warrant substantive audit tests if they are not significant in the aggregate. However, some line items and accounts with zero or unusual balances may warrant testing, particularly with regard to the completeness assertion.
- .02 Financial statement assertions, as presented in AU-C 315, are management representations that are embodied in financial statement components. Most of the auditor's work in forming an opinion on financial statements consists of obtaining and evaluating sufficient appropriate evidence concerning the assertions in the financial statements. The assertions can be either explicit or implicit. The FAM classifies assertions into the following five broad categories:
- **Existence or occurrence:** Recorded transactions and events occurred during the given period, are properly classified, and pertain to the entity. An entity's assets, liabilities, and net position exist at a given date.
  - **Completeness:** All transactions and events that should have been recorded are recorded in the proper period. All assets, liabilities, and net position that should have been recorded have been recorded in the proper period and properly included in the financial statements.
  - **Rights and obligations:** The entity holds or controls the rights to assets, and liabilities are the obligations of the entity at a given date.
  - **Accuracy/valuation or allocation:** Amounts and other data relating to recorded transactions and events have been recorded appropriately. Assets, liabilities, and net position are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are properly recorded. Financial and other information is disclosed fairly and at appropriate amounts.
  - **Presentation and disclosure:** The financial and other information in the financial statements is appropriately presented and described, and disclosures are clearly expressed. All disclosures that should have been included in the financial statements have been included. Disclosed events, transactions, and other matters have occurred and pertain to the entity. (AU-C 315.A114c.i)

AU-C 315 contains 13 assertions within three categories. See FAM 235.08 for a comparison of the above five assertions to the 13 assertions in AU-C 315.

- .03 The auditor should determine whether each line item or account in the financial statements is significant. A significant item usually has one or more of the following characteristics:
- Its balance or activity equals or exceeds performance materiality.
  - A high risk of material misstatement (combined inherent and control risk, as discussed in FAM 260.02) is associated with one or more assertions relating to the line item or account. For example, a zero or unusually small balance account may have a high risk of material misstatement with respect to the completeness assertion.
  - Special audit concerns, such as legal or regulatory requirements, warrant added consideration.

The auditor should determine whether any accounts considered individually insignificant are significant in the aggregate.

- .04 An assertion is significant (relevant) if misstatements in the assertion could exceed performance materiality for the related line item, account, or disclosure. Additionally, in determining whether a particular assertion is relevant to a significant account balance or disclosure, the auditor should evaluate (1) the nature of the assertion; (2) the volume of transactions or data related to the assertion; and (3) the nature and complexity of the systems, including both manual and information systems, the entity uses to process and control information supporting the assertion (see FAM 270).
- .05 Certain assertions for a specific line item or account, such as completeness and disclosure, could be significant even though the recorded balance of the related line item or account is not material. For example, (1) the completeness assertion could be significant for an accrued payroll account with a high risk of material understatement even if its recorded balance is zero and (2) the disclosure assertion could be significant for a loss contingency even if no amount is required to be recorded.
- .06 Assertions are likely to vary in degree of significance, and some assertions may be insignificant or irrelevant for a given line item or account. For example,
- the completeness assertion for liabilities may be of greater significance than the existence assertion for liabilities and
  - all assertions related to an account that is not significant (as defined in FAM 235.03) are considered to be insignificant.
- .07 The auditor should document significant line items, accounts, and relevant assertions in the Line Item Risk Analysis (LIRA) or other appropriate audit planning documentation (see FAM 395 H). The auditor should also document assertions related to budget-related balances and transactions included in the financial statements in the LIRA or other audit documentation. FAM 395 F provides detailed control objectives for budget-related information.
- .08 AU-C 315.A114 identifies three categories of assertions: (1) classes of transactions and events for the period under audit, (2) account balances at the period end, and (3) presentation and disclosure. Within these three categories, AU-C 315 identified 13 assertions. The auditor may use these assertions or may express them differently, provided all the aspects of the assertions are addressed

(AU-C 315.A115). The table below compares the expanded assertions in AU-C 315 to the assertions in FAM 235.02.

**Table FAM 235.08: Comparison of AU-C 315 Assertions to FAM 235.02 Assertions**

| AU-C 315 assertions  | FAM 235.02 assertions   |
|--|---|
| <b>I. Assertions about classes of transactions and events for the period under audit</b>                                   |   |
| 1. <b>Occurrence</b> – Transactions and events that have been recorded have occurred and pertain to the entity.            | 1. <b>Existence or occurrence – Recorded transactions and events have occurred during the given period</b> , are properly classified, <b>and pertain to the entity</b> . An entity's assets, liabilities, and net position exist at a given date.   |
| 2. <b>Completeness</b> – All transactions and events that should have been recorded have been recorded.                    | 2. <b>Completeness – All transactions and events that should have been recorded are recorded in the proper period</b> . All assets, liabilities, and net position that should have been recorded have been recorded in the proper period and properly included in the financial statements.   |
| 3. <b>Accuracy</b> – Amounts and other data relating to recorded transactions and events have been recorded appropriately. | 4. <b>Accuracy/valuation or allocation – Amounts and other data relating to recorded transactions and events have been recorded appropriately</b> . Assets, liabilities, and net position are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are properly recorded. Financial and other information is disclosed fairly and in appropriate amounts. |

| AU-C 315 assertions  | FAM 235.02 assertions  |
|--|--|
| 4. <b>Cutoff</b> – Transactions and events have been recorded in the correct accounting period.  | 1. <b>Existence or occurrence – Recorded transactions and events have occurred during the given period</b> , are properly classified, and pertain to the entity. An entity's assets, liabilities, and net position exist at a given date.<br><br>2. <b>Completeness – All transactions and events that should have been recorded are recorded in the proper period</b> . All assets, liabilities, and net position that should have been recorded have been recorded in the proper period and properly included in the financial statements. |
| 5. <b>Classification</b> – Transactions and events have been recorded in the proper accounts.  | 1. <b>Existence or occurrence – Recorded transactions and events</b> have occurred during the given period, <b>are properly classified</b> , and pertain to the entity. An entity's assets, liabilities, and net position exist at a given date.   |
| <b>II. Assertions about account balances at the period end</b>   |  |
| 6. <b>Existence</b> – Assets, liabilities, and equity interests exist.   | 1. <b>Existence or occurrence</b> – Recorded transactions and events have occurred during the given period, are properly classified, and pertain to the entity. <b>An entity's assets, liabilities, and net position exist at a given date.</b>  |
| 7. <b>Rights and obligations</b> – The entity holds or controls the rights to assets, and liabilities are the obligations of the entity. | 3. <b>Rights and obligations</b> – The entity holds or controls the rights to assets, and liabilities are the obligations of the entity at a given date.   |

| AU-C 315 assertions   | FAM 235.02 assertions  |
|---|--|
| 8. <b>Completeness</b> – All assets, liabilities, and equity interests that should have been recorded have been recorded.   | 2. <b>Completeness</b> – All transactions and events that should have been recorded are recorded in the proper period. <b>All assets, liabilities, and net position that should have been recorded have been recorded in the proper period</b> and properly included in the financial statements.  |
| 9. <b>Valuation and allocation</b> – Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are appropriately recorded. | 4. <b>Accuracy/valuation or allocation</b> – Amounts and other data relating to recorded transactions and events have been recorded appropriately. <b>Assets, liabilities, and net position are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are properly recorded.</b> Financial and other information are disclosed fairly and in appropriate amounts. |
| <b>III. Assertions about presentation and disclosure</b>  |  |
| 10. <b>Occurrence and rights and obligations</b> – Disclosed events, transactions, and other matters have occurred and pertain to the entity.   | 5. <b>Presentation and disclosure</b> – The financial and other information in the financial statements is appropriately presented and described, and disclosures are clearly expressed. All disclosures that should have been included in the financial statements have been included. <b>Disclosed events, transactions, and other matters have occurred and pertain to the entity.</b>                                      |

| AU-C 315 assertions   | FAM 235.02 assertions   |
|---|---|
| <p>11. <b>Completeness</b> – All disclosures that should have been included in the financial statements have been included.</p>                                 | <p>5. <b>Presentation and disclosure</b> – The financial and other information in the financial statements is appropriately presented and described, and disclosures are clearly expressed. <b>All disclosures that should have been included in the financial statements have been included.</b> Disclosed events, transactions, and other matters have occurred and pertain to the entity.</p>                                      |
| <p>12. <b>Classification and understandability</b> – Financial information is appropriately presented and described, and disclosures are clearly expressed.</p> | <p>5. <b>Presentation and disclosure</b> – <b>The financial and other information in the financial statements is appropriately presented and described, and disclosures are clearly expressed.</b> All disclosures that should have been included in the financial statements have been included. Disclosed events, transactions, and other matters have occurred and pertain to the entity.</p>                                      |
| <p>13. <b>Accuracy and valuation</b> – Financial and other information is disclosed fairly and in appropriate amounts.</p>                                      | <p>4. <b>Accuracy/valuation or allocation</b> – Amounts and other data relating to recorded transactions and events have been recorded appropriately. Assets, liabilities, and net position are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are properly recorded. <b>Financial and other information are disclosed fairly and in appropriate amounts.</b></p> |



## **240 – Identify Significant Accounting Applications, Cycles, and Financial Management Systems**

- .01 In the planning and internal control phases, the auditor should identify controls for each significant accounting application and cycle and assess the risk of material misstatement for each significant assertion. See also FAM 310.10 through .13 and FAM 640 for further details on service organizations. For CFO Act agencies, which are subject to FFMIA, the auditor also determines whether the financial management systems comply substantially with (1) federal financial management systems requirements, (2) federal accounting standards, and (3) the SGL at the transaction level. See FAM 701 for additional guidance on determining whether an agency's financial management systems comply substantially with the three requirements of FFMIA and FAM 701 A for related example audit procedures.

An accounting application comprises the methods and records used to (1) identify, assemble, analyze, classify, and record a particular type of transaction or (2) report recorded transactions and maintain accountability for related assets and liabilities. A cycle is a grouping of related accounting applications. Accounting applications often include information system processing. Information system processing is often performed by software programs hosted by information systems, which are also commonly referred to as applications.

- .02 An accounting application or cycle is generally significant if it processes aggregate transactions in excess of performance materiality or if it supports a significant line item or account balance in the financial statements. Each significant line item or account is affected by input from one or more accounting applications. Accounting applications are classified as (1) transaction related or (2) line item/account related.
- .03 A transaction-related accounting application consists of the methods and records established to identify, assemble, analyze, classify, and record (in the general ledger) a particular type of transaction. Transaction-related accounting applications are sources of debits or credits. Typical transaction-related accounting applications include billing, cash receipts, purchasing, cash disbursements, and payroll. A line item/account-related accounting application consists of the methods and records established to report recorded transactions and maintain accountability for related assets and liabilities. Typical line item/account-related accounting applications include cash balances, accounts receivable, inventory, property and equipment, and accounts payable.

- .04 An accounting system comprises the methods, records, and processes used to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. The entity's accounting system may be viewed as consisting of logical groupings of accounting applications.
- The entity may group related accounting applications into organizational units or financial management systems. 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. For example, for the billing transaction-related accounting application, different manual processes and possibly different financial management systems may be used by the organizational unit (or units) responsible for billing.
- The auditor may group related accounting applications into cycles irrespective of the organizational units or financial management systems involved. For instance, the auditor may group the billing (transaction related), cash receipts (transaction related), and accounts receivable (line item/account related) accounting applications to form the revenue cycle.
- .05 Grouping related accounting applications into cycles can aid the auditor in preparing audit documentation and in designing audit procedures that are effective, efficient, and relevant to the reporting objectives. The auditor should prepare a **cycle matrix** or equivalent document that links each of the entity's accounts (in the chart of accounts) to a cycle, an accounting application, and a financial statement line item. For each significant accounting application included on the cycle matrix (or equivalent document), the auditor should obtain an understanding of the information system processing included therein. This understanding will form the basis for the auditor's cycle memorandums, which are described in FAM 320, and the auditor's identification of relevant control activities, as described in FAM 340.
- .06 For each significant financial statement line item, the auditor should use the LIRA form at FAM 395 H or equivalent audit documentation to identify the significant transaction cycles (such as revenue, purchasing, and production) and the significant accounting applications that affect these significant line items and related assertions. For example, the auditor might determine that billing, cash receipts, and accounts receivable are significant accounting applications that affect accounts receivable (a significant line item). The LIRA form provides a convenient way to document the specific risks of material misstatement by assertion for significant line items so that they can be considered in determining the nature, extent, and timing of audit procedures. If the auditor uses an equivalent type of audit documentation, rather than the LIRA form, the auditor should include the information discussed in FAM 395 H.
- .07 Based on discussions with entity personnel and the auditor's understanding of the significant accounting applications, the auditor should determine which financial management systems are significant. If the auditor decides that one or more of the accounting applications making up a financial management system are significant, that financial management system generally is significant for

evaluating the effectiveness of the entity's internal control over financial reporting.

If the auditor determines that a financial management system is significant for evaluating the effectiveness of the entity's internal control over financial reporting, that financial management system generally is significant for determining whether the system complies substantially with the three requirements of FFMIA. In addition to 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 portion of mixed systems, such as benefit payment, logistics, personnel, and acquisition systems.

If the auditor determines that a financial management system maintained by a service organization is significant for evaluating the effectiveness of the entity's internal control over financial reporting, then the auditor should follow the guidance outlined in FAM 640.05 through .10.

- .08 The auditor may also identify accounting applications, cycles, or financial management systems as significant based on qualitative considerations. For example, financial management systems that contain subsidiary records for receivables, property, and payables typically provide detailed information for testing and support for general ledger balances if appropriate reconciliations are performed. When a significant line item has more than one source of financial information, the auditor should consider the various sources and determine which is best for financial audit purposes. The auditor should evaluate the likelihood of misstatement and auditability in choosing the source to use. For audit purposes, the best source of financial information sometimes may be operational information prepared outside the accounting system.
- .09 The auditor should obtain sufficient knowledge of the significant accounting applications to understand the design of the procedures by which transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements (see AU-C 315.19 and FAM 320). Accounting applications often include information system processing. As discussed in AU-C 315, the auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor deems necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures that respond to assessed risks. See FAM 260 for further discussion on identifying risk factors and FAM 340 for further discussion on identifying and understanding relevant control activities.
- .10 During the internal control phase, the auditor will determine whether the controls identified were implemented as designed. As noted in FAM 310.02, OMB audit guidance requires the auditor to perform sufficient tests of controls that have been suitably designed and implemented to conclude whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk).<sup>1</sup> Thus, the auditor should not elect to forgo control tests

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<sup>1</sup>Control risk is defined in AU-C 200.14 as "the risk that a misstatement that could occur in an assertion about a class

solely because it is more efficient to extend substantive and compliance audit procedures.

- .11 When significant accounting applications include control activities that are dependent on information system processing, the auditor should assess information system (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.
- .12 IS controls consist of those internal controls that are dependent on information system processing and include general controls, application controls, and user controls. Information system general controls (implemented at the entitywide, system, and application levels) are the structure, policies and procedures that apply to all or a large segment of an entity's information systems. 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).
- .13 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

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of transaction, account balance, or disclosure 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." Control risk assessment is discussed in FAM 370.

- 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.
- .14 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 the information that information systems produce. A user control can be an IS control or a manual control. A user control is considered an IS control if a dependency on information system processing exists. 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 no dependency on information system processing exists. 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.
- .15 In the planning phase, the auditor should identify and document the control activities included in the significant accounting applications that are dependent 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 entitywide, system, and application levels that help ensure the effective operation of the application and user controls included in the significant accounting applications. Due to 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.
- .16 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 FISCAM when assessing IS controls in a financial statement audit. The FISCAM is designed to meet these requirements, and GAO believes that the 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. Information system security controls are also addressed in OMB Circular No. A-130, *Managing Information as a Strategic*

*Resource*, in the National Institute of Standards and Technology's (NIST) *An Introduction to Computer Security: The NIST Handbook*, National Security Agency guidance on Microsoft and other computer vendor web sites, and in various publications. OMB's guidance on reporting under the Federal Information Security Modernization Act of 2014 (FISMA) specifies NIST publications to be used by agencies when evaluating information security. See FAM 260.

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

- .01 AU-C 250 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.
- .02 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 basic 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 disclosures. The concept of direct effect is also discussed in AU-C 250.

- .03 The significant provisions identified by the procedures discussed below are intended to include provisions of all laws, regulations, contracts, and grant agreements that have a direct effect on determining material amounts and disclosures in the financial statements and therefore comply with GAGAS and AU-C 935.
- .04 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.
- .05 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.
- .06 The auditor should identify the significant provisions of 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 on 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/summarization of quantitative information 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, as amended, 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 of 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 perform testing of the budgetary and proprietary transactions associated with lease agreement provision.

- .07 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:
- a. 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. OGC provides assistance to the auditor in identifying laws and regulations. The meaning of direct effect is discussed in FAM 245.02.
  - b. Identify those provisions that are significant for each applicable law, regulation, contract, or grant agreement. 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 processed by the entity that is subject to the provision equals or exceeds materiality.
    - **Quantitative-based provisions:** The quantitative information required by the provision or by established restrictions 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.
- c. 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 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.
- .08 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:
- a. 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).
  - b. 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.
  - c. 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.
  - d. 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).
- .09 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 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.

- .10 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.
- .11 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 460.07 for the procedures to perform for instances of noncompliance or suspected noncompliance with laws, regulations, contracts, or grant agreements (whether direct or indirect).

## **250 – Identify Relevant Budget Restrictions**

- .01 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 in Sections 1341, 1342, 1349 through 1351, and 1517 of Title 31, U.S. Code;
  - the Purpose Statute, as provided in Section 1301 of Title 31, U.S. Code;
  - the Time Statute, as provided in Section 1502 of Title 31, U.S. Code;
  - OMB Circular No. A-11, *Preparation, Submission and Execution of the Budget*, Part 4;
  - the Impoundment Control Act, as provided in Chapter 17B of Title 2, U.S. Code; and
  - the Federal Credit Reform Act (FCRA), as provided in Sections 661 through 661f of Title 2, U.S. Code (if the entity has activity subject to this law).
- 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 SGL within the *Treasury Financial Manual* (TFM) provides guidance on budgetary accounting.
- .02 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.

- .03 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.
- .04 The auditor should obtain advice from 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.
- .05 During these discussions with OGC and the entity, the auditor should determine whether any of these relevant budget restrictions relate to significant provisions of laws and regulations for purposes of testing compliance.
- .06 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 – Identify Risk Factors**

- .01 The auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. The risk assessment procedures should include the following: (a) inquiries of management and others within the entity who, in the auditor's professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error; (b) analytical procedures; and (c) observation and inspection (AU-C 315.06). Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion (AU-C 315.05). The auditor's assessments of inherent risk and control risk affect the auditor's assessment of the risks of material misstatement. The risks of material misstatement affect the nature, extent, and timing of other audit procedures, including substantive procedures and control tests. This section describes (1) the relationship of identified risk factors to the risk of material misstatement and the impact on substantive procedures and control tests, (2) the process for identifying these risk factors, and (3) the auditor's consideration of the entity's process for reporting under FMFIA both for internal control and for financial management systems' conformance with system requirements and formulating the budget.

### **Audit Risk Components**

- .02 AU-C 200 provides guidance on audit risk and defines "audit risk" 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 (see AU-C 200.14 and *Standards for Internal Control in the Federal Government* (Green Book)):
- **Inherent risk** is the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  - **Control risk** is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure 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. That 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.
- Internal control consists of five components: (1) the control environment, (2) entity risk assessment, (3) monitoring, (4) information and communication, and (5) control activities (defined in FAM 260.09) and 17 related principles. This section discusses the first three of the components and communication, which is part of the fourth component. FAM 300 (Internal Control Phase) discusses the information systems and control activities.

- **Fraud risk** is a part of audit risk, making up a portion of inherent and control risk. Fraud risk consists of the risk of fraudulent financial reporting and the risk of misappropriation of assets that cause a material misstatement of the financial statements (Green Book 8.02). The auditor should specifically assess and document the risks of material misstatement of the financial statements due to fraud and should consider fraud risk in designing audit procedures. The auditor may determine the risks of material fraud concurrently with the consideration of inherent and control risk but should form a separate conclusion on fraud risk. As the auditor obtains audit evidence during the audit, the auditor should consider its potential effect on the auditor's assessment of fraud risk. FAM 290 includes documentation for fraud risk.
- **Risk of material misstatement** is the risk that the financial statements are materially misstated prior to the audit. It is the auditor's combined assessment of inherent risk and control risk. The auditor may separately assess inherent risk and control risk when determining the risk of material misstatement. The auditor should assess the risk of material misstatement at the relevant assertion level as a basis for further audit procedures. Although this assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for the assessment.
- **Detection risk** is the risk that the procedures performed by the auditor 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. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk relates to the substantive procedures and is managed by the auditor's response to the risk of material misstatement.

## Impact on Substantive Procedures

- .03 Based on the level of audit risk and the risks of material misstatement, including the consideration of fraud risk, the auditor should determine the nature, extent, and timing of substantive procedures necessary to achieve the level of acceptable 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).
- .04 Audit assurance is the complement of audit risk. Assurance equals 100 percent minus the percentage of allowable risk.<sup>1</sup> The audit organization should determine the level of assurance to use, which may vary between audits based on risk.

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<sup>1</sup>Audit assurance is not the same as statistical confidence. Audit assurance is a combination of quantitative measurement and auditor judgment.

GAO auditors should use 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.

- .05 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 level of audit assurance should be approved by the reviewer.

## Relationship to Control Assessment

- .06 Internal control, as defined in AU-C 315.04, is a process affected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.<sup>2</sup>
- .07 Internal control over financial reporting, as defined in OMB audit guidance, is a subset of the entity's internal control and includes (GAGAS and OMB audit guidance expand compliance to include contracts and grant agreements.):
- **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 (see FAM 310.05 through .07) are part of financial reporting controls, although they are also operations controls.)
  - **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 the net cost of operations to budget note disclosure, and 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.)
- .08 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

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<sup>2</sup>See also GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G (September 2014). (See para. OV1.01, specifically.)

monitor inventory levels to better control operations and make procurement decisions (operations controls).

- .09 The five components of internal control relate to objectives that an entity strives to achieve in each of the three categories: financial reporting (including safeguarding), compliance, and operations controls. The components in AU-C 315, Green Book OV2.04 and 2.09, and AU-C 940 are as follows:
- **Control environment** sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
  - **Risk assessment** is the entity's identification, analysis, and management of risks relevant to achievement of its objectives. This assessment provides the basis for developing appropriate responses to risk.
  - **Information<sup>3</sup> and communication** systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
  - **Monitoring** of controls is a process to assess the effectiveness of internal control performance over time. This consists of 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** are the policies, procedures, techniques, and mechanisms that help ensure that management directives are carried out and respond to risks in the internal control system, which includes the entity's information system.

## Inherent Risk Factors

- .10 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.

The auditor may limit the assessment of inherent risk to significant programs, transactions, or accounts. Inherent risks may relate to the entity overall or to specific accounts and assertions. For each factor listed below, FAM 295 A lists conditions that may indicate inherent risk.

- a. **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

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<sup>3</sup>The information component of internal control, as defined in AU-C 315, is in the context of a financial statement audit, whereas *Standards for Internal Control in the Federal Government* defines the information component in the context of internal control overall.



example, student loan guarantee programs may be more susceptible to errors and fraud because of loans issued and serviced by third parties.

- b. **Prior history of significant audit adjustments:** Significant audit adjustments identified in previous financial statement audits or other audits often identify inherent or control risks that may allow financial statement misstatements. 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;
  - understanding management's response to such conditions (including implementation of controls), if any; and
  - assessing the nature and extent of the related inherent and control risk.
- c. **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.

## Information Systems' Effect on Inherent Risk

- .11 Information systems do not affect the audit objectives for an account or a cycle. However, information systems (or lack thereof) can introduce inherent risk factors not present in a manual accounting system. The auditor should (1) consider each of the following information system factors and (2) assess the overall impact of information system processing on inherent risk. The impact of these factors typically will be pervasive in nature. An IS controls auditor may assist the auditor in considering these factors and making this assessment. More detail on assessing information system risks and controls in a financial statement audit is available in the FISCAM, and a flowchart of steps is in FAM 295 J.
- a. **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.
  - b. **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.
  - c. **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. Due to the electronic form, changes to software programs and data may not be readily detectable. 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).

- d. **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.
- e. **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.
  - Due to 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)
- f. **Unusual or nonroutine transactions:** As with manual systems, unusual or nonroutine information system 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. For example, the entity may use a utility program to extract specified information in support of a nonroutine management decision.

## Fraud Risks

- .12 The auditor should identify and assess the **risks of material misstatement due to fraud (fraud risk)** at the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures (AU-C 240.25). The primary factor that distinguishes fraud from error is that the action causing the misstatement in fraud is intentional. (See FAM 230 related to materiality, including quantitative and qualitative considerations.)
- .13 Two types of misstatements are relevant to the auditor's consideration of fraud in an audit of financial statements are as follows:
- **Misstatements resulting from fraudulent financial reporting** are intentional misstatements, including omissions of amounts or disclosures in 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 internal control over safeguarding assets. Safeguarding controls relate to protecting assets against loss from unauthorized acquisition, use, or disposition.) (Green Book 8.02)
- .14 In considering misstatements resulting from misappropriation of assets, the auditor should consider fraud risks associated with improper payments. Some of the improper payments that federal government entities make could involve fraud. The Improper Payments Information Act of 2002 (Pub. L. No. 107-300), as amended by the Improper Payments Elimination and Recovery Act of 2010 (Pub. L. No. 111-204) and the Improper Payments Elimination and Recovery Improvement Act of 2012 (Pub. L. No. 112-248) and reprinted in 31 U.S.C § 3321 note, 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. OMB guidance 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.
- The act 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.<sup>4</sup> An entity must produce a statistically valid (or otherwise approved by OMB) estimate of annual improper payments for those identified programs and report those estimates in the

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<sup>4</sup>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.

accompanying materials to the annual 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.

- .15 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 if they become 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).

### **Characteristics of Fraud**

- .16 Three conditions generally are present when fraud occurs:
- **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.
  - **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.
  - **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)
- .17 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).

## **Fraud Risk Factors**

- .18 Although fraud is usually concealed, the presence of **fraud risk factors** that indicate incentive/pressure, opportunity, or attitude/rationalization might alert the auditor to risks of material misstatement. While fraud risk may be greatest when all three risk factors are present, one or more of these factors may indicate fraud risk. Other information provided by internal and external parties can also be used to identify fraud risks (Green Book 8.05). However, fraud risk factors do not necessarily indicate that fraud exists. Examples of fraud risk factors, classified by the two types of fraudulent misstatements and then by these three conditions, follow.
- a. Examples related to misstatements resulting from fraudulent financial reporting are as follows:
    - **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.
  - b. Examples related to misstatements resulting from misappropriation of assets are as follows:
    - **Incentive/pressure**—Employees who are disgruntled because of impending layoffs have an incentive to misappropriate assets, or 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.

Fraud risk factors represent inherent or control risk factors. As discussed in FAM 260.02, the auditor should evaluate fraud risk factors in assessing inherent and control risk. FAM 295 A and FAM 295 B include additional examples of fraud risk factors.

## **Information for Identifying Fraud Risks**

- .19 To obtain information about fraud risks, the auditor should inquire of management about (AU-C 240.17 and 240.18)
- a. any knowledge of actual, suspected, or alleged fraud affecting the entity (including fraudulent improper payments);

- b. 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;
  - c. 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, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist (including information about any fraudulent improper payments that the entity identified in making assessments related to the Improper Payments Information Act of 2002, as amended) (Green Book 8.06);
  - d. management's communication, if any, to employees regarding its views on business practices and ethical behavior; and
  - e. 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 federal entities) or others with equivalent authority and responsibility, regarding its processes for identifying and responding to the risks of fraud in the entity.
  - f. Inquiries of management and others within the entity should be made in person when possible. In-person discussions are usually the most effective. The auditor may also find it helpful to provide the interviewee with specific questions and obtain written responses in advance of the discussion.
- .20 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:
- a. 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.
  - b. 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 internal control 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 and whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity. 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 and 9.03).

- Inquire of those charged with governance to determine whether management performs a 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).
- c. Inquire of internal audit personnel to obtain their views about the risks of fraud; determine whether it has knowledge of any actual, suspected, or alleged fraud; whether it has performed any procedures to identify or detect fraud during the reporting period; and whether management has satisfactorily responded to any findings resulting from these procedures (AU-C 240.19).
- d. 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).

- .21 The auditor also should perform the following procedures:
- a. 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 the Improper Payments Information Act of 2002, as amended.
  - b. 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).
  - c. 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).

## **Responding to Assessed Fraud Risks**

- .22 The auditor should respond to the assessed risks of material misstatement due to fraud at the financial statement and assertion levels, as discussed in FAM

260.22 through .26 and AU-C 240.28 and 940.17. The nature and significance of these fraud risks, as well as programs and controls that address identified 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. The response should (1) affect the overall conduct of the audit (see FAM 260.24); (2) address fraud risks that relate to management override of controls (see FAM 260.25); and (3) for any of these risks that relate to specific financial statement account balances or classes of transactions and related assertions, involve the nature, extent, and timing of audit procedures (see FAM 260.26). 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.

- .23 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.
- .24 In determining the overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor should do the following:
  - a. 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).
  - b. Evaluate whether the selection and application of accounting policies by the entity, 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).
  - c. 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.

- .25 The auditor should perform procedures to specifically address the risk that management can perpetrate fraud by overriding controls as follows (AU-C 240.32):

- a. **Examination of journal entries and other adjustments**—Test the appropriateness of journal entries and other adjustments. These include reclassifications, consolidating entries, and other routine and nonroutine journal entries and adjustments. The auditor should
- obtain an understanding of the financial reporting process and the controls over journal entries and other adjustments and the suitability of design and implementation of such controls;
  - 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 entries processed outside the normal course of business;
  - 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.
- b. **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. 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, focusing on highly sensitive or subjective aspects, to determine whether they indicate possible bias by management. For example, significant changes in allowances for uncollectible accounts that may be tied to performance measures in an effort to improve collections.

- c. **Evaluation of business rationale for significant unusual transactions**—Evaluate whether the business rationale for any significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual suggest that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets (AU-C 240.32c). Indicators include the following (AU-C 240.A54):

- the form of these transactions is overly complex;
  - management has not discussed the nature of and accounting for these transactions with those charged with governance;
  - management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction;
  - transactions that involve related parties have not been properly reviewed or approved by those charged with governance; and
  - transactions that involve previously unidentified related parties (see FAM 902) or related parties that do not have the substance or financial strength to support the transactions without assistance from the entity.
- d. **Determine necessity of other procedures**—Determine whether other audit procedures, in addition to those discussed above in FAM 260.25a.-c., are needed to address the risks of management override (AU-C 240.33).
- .26 For fraud risks related to specific financial statement account balances or classes of transactions and related assertions, the specific response will depend on the types of risks and the specific balances or classes and assertions, but it generally should involve both substantive procedures and control tests. The response should involve one or more of the following (AU-C 240.A43):
- a. **Nature** of audit procedures—for example, obtaining related evidence from independent external sources rather than internal sources.
  - b. **Extent** of audit procedures—for example, increasing sample sizes.
  - c. **Timing** of audit procedures—for example, performing substantive procedures at or near the end of the reporting period rather than at an interim date.
- FAM 295 I provides additional examples of responses.

## Understand and Assess Internal Control Components

- .27 The auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit (AU-C 315.13). When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel (AU-C 315.14). The auditor should obtain an understanding of and assess the five components of internal control (control environment, risk assessment, information and communication, monitoring, and control activities) relevant to the audit (AU-C 315.13). The auditor should then identify the existence of risk factors for each of these components. See further discussion below.

## Process for Identifying Risk Factors

- .28 In the planning phase, the auditor should (1) identify conditions that significantly increase inherent and control risk and (2) conclude whether any identified control risks preclude the effectiveness of specific control activities in significant accounting applications. The auditor should consider the results of the assessment of the risk of material misstatement due to fraud along with other information gathered in the process of identifying the risks of material misstatements (AU-C 315.09). The auditor should also consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement (AU-C 315.07). If the engagement partner has performed other engagements for the entity, the engagement partner should consider whether information obtained is relevant to identifying risks of material misstatement (AU-C 315.08). The auditor should identify specific inherent risks; fraud risks; and control environment, entity risk assessment, communication, and monitoring deficiencies based on information obtained in the planning phase, primarily from understanding the entity's operations, including significant information system processing performed outside the entity and preliminary analytical procedures.

See FAM 260.45 through .62 for additional discussions of control environment, entity risk assessment, communication, monitoring, and the auditor's responsibility for understanding each of these components. See FAM 290.06 for documentation requirement related to understanding each component.

- .29 Factors to consider in identifying risks and deficiencies are listed in this section. These factors are general in nature and require the auditor's judgment in determining (1) the extent of procedures (testing) to identify the risks and deficiencies and (2) the impact of such risks and deficiencies on the entity and its financial statements. Because this risk consideration requires the exercise of significant audit judgment, it should be performed by experienced audit team personnel. In addition, specific conditions that may indicate inherent or fraud risks or control environment, entity risk assessment, communication, or monitoring deficiencies are in FAM 295 A and FAM 295 B, respectively. These sections are designed to aid the auditor in identifying these risks and deficiencies but are not all inclusive. The auditor should evaluate any other factors and conditions deemed relevant.
- .30 The auditor should evaluate the degree of estimation uncertainty associated with accounting estimates as part of identifying risk factors (AU-C 540.10). The auditor should determine whether, in the auditor's professional judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks (see FAM 260.43 below). As part of the auditor's risk assessment procedures, the auditor should review the outcome of accounting estimates included in the prior period financial statements or, when applicable, their subsequent reestimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the auditor's professional

judgments made in the prior periods that were based on information available at the time (AU-C 540.09).

- .31 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. In light of this inherent risk, the entity should have strong operations controls to monitor the entity's 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.
- .32 Service organization reports, which are discussed further in FAM 310, FAM 640, and AU-C 402, may be prepared by auditors for service organizations (also referred to as service auditors) performing services for user entities that are relevant to those user entities' internal control over financial reporting. The auditor may find these reports useful for performing risk assessments and planning other audit procedures.
- .33 If applicable to the entity, the auditor should obtain an understanding of the entity's process for compliance with FMFIA and OMB Circular No. A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control* (see FAM 260.65 through .70), and whether the process has been implemented, and should obtain an understanding of the budget formulation process (see FAM 260.78).

## Brainstorming About the Risks of Material Misstatement

- .34 As required by AU-C 315.11, the engagement partner (typically the audit director) and other key engagement team members should brainstorm (discuss) the susceptibility of the entity's financial statements to material misstatement and the application of the applicable financial reporting framework to the entity's facts and circumstances. The objective of this discussion is for the audit team members to gain a better understanding of the potential for material misstatement of the financial statements resulting from fraud or error 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 decisions about the nature, extent, and timing of further audit procedures.

These discussions provide an opportunity for more experienced team members to share insights based on their knowledge of the entity and for the team members to exchange information about the business risks related to the entity. 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.

- .35 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 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).

- .36 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 related party relationships and transactions (AU-C 550.13).<sup>5</sup> The auditor may discuss matters such as (1) the nature and extent of the entity's relationships and transactions with related parties, (2) the records or documents that may indicate the existence of related party relationships or transactions, and (3) how related parties may be involved in fraud. See AU-C 550.A7 through .A8 for additional matters that may be discussed.
- .37 Key members of the audit 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 audit team are factors that influence the extent of the discussion.
- .38 The engagement partner should determine which matters to communicate to any audit team members not involved in the discussion (AU-C 315.11 and 240.15). For example, if separate discussions are held with the key staff at various locations for a multi-location audit, it is not necessary for all members of the audit team to be informed of all the decisions reached in the discussion.

## Identify Risks of Material Misstatement

- .39 To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at (a) the

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<sup>5</sup>Such related party relationships and transactions may include, as defined by FASAB, disclosure entities, related parties, and public-private partnerships (FAM 904.03).

financial statement level and (b) the relevant assertion level for classes of transactions, account balances, and disclosures (AU-C 315.26). The auditor should (a) identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, by considering the classes of transactions, account balances, and disclosures in the financial statements; (b) assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions; (c) relate the identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test; and (d) consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement (AU-C 315.27).

The auditor should identify and document risks of material misstatement due to error or fraud at the financial statement and assertion levels, as discussed in AU-C 315 and 240, after considering (1) knowledge obtained about the entity (obtained in previous steps in the planning phase); (2) the risk factors discussed in this section, AU-C 315, AU-C 240, FAM 295 A, and FAM 295 B; and (3) other relevant factors.

For fraud risks (including any related to fraudulent improper payments and related parties), the auditor should evaluate the information obtained in the procedures described in FAM 260.19 through .21, in the context of the fraud risk factors that generally are present when fraud occurs—incentive/pressure, opportunity, and attitude/rationalization. Although fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances in which frauds have occurred and, therefore, may indicate risks of material misstatement due to fraud (AU-C 240.24). AU-C 240 requires additional responses to fraud risks, as discussed in FAM 260.22 through .26.

The auditor should document these risks and deficiencies and their impact on proposed audit procedures in the audit strategy (see FAM 290). The auditor also should summarize and document any inherent or fraud risks or control environment deficiencies that affect the specific line item on the LIRA form or equivalent (see FAM 290 and FAM 395 H).

- .40 For each risk factor identified, the auditor should document the nature and extent of the risk or deficiency; the condition(s) that gave rise to that risk or deficiency; and the specific cycles, accounts, line items, and related assertions affected (if not pervasive). For example, the auditor may identify a 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 (inherent risk), and (3) management's history of aggressively challenging any proposed adjustments to the valuation of the receivables (control environment weakness). The auditor should also document other considerations that may mitigate the effects of identified risks and deficiencies. In documenting these considerations, the audit should evaluate whether the entity's controls sufficiently address identified risk of material misstatement due to fraud and the risk of management override of other controls (AU-C 940.16). For example, the use of a lockbox (a control activity) may mitigate inherent risks associated with the completeness of cash receipts.

- .41 The auditor also should document, in the audit strategy, any risks of material misstatement that relate pervasively to the financial statements taken as a whole that potentially affect many relevant assertions. These may relate to the overall effectiveness of the control environment, entity risk assessment, communication, and monitoring, including whether deficiencies preclude the effectiveness of specific control activities. The focus should be on management's **overall** attitude, awareness, and actions, including the ability to override existing controls, rather than on specific conditions related to a control environment, entity risk assessment, communication, or monitoring factor. The auditor should use this assessment when determining the risks of material misstatement for specific accounts and assertions.

When developing responses to these types of risks of material misstatement at the overall financial statement level, the auditor should consider matters such as the knowledge, skill, and ability of personnel assigned significant engagement responsibilities; whether certain aspects of the engagement need the involvement of a specialist; and the appropriate level of supervision of audit staff. AU-C 330.A1 discusses the auditor's overall responses to address the assessed risks of material misstatement at the financial statement level.

- .42 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. 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 (see FAM 290.06n) (AU-C 240.26 and 240.46).

- .43 The auditor should determine which of the risks identified require special audit consideration. These risks are defined as "significant risks" by AU-C 315. In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk (AU-C 315.28). In exercising professional judgment about which risks are significant risks, the auditor should consider at least (a) whether the risk is a risk of fraud; (b) whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention; (c) the complexity of transactions; (d) whether the risk involves significant transactions with related parties; (e) the degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and (f) whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual (AU-C 315.29). The auditor should treat those assessed risks of material misstatement due to fraud as significant risks (AU-C 240.27). The results of these procedures assist the auditor in developing an effective audit approach, as discussed in FAM 300 and 400.

In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are

relevant to the audit, and the auditor should obtain an understanding of them (AU-C 315.31).

- .44 The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances in which the auditor obtains audit evidence from performing further audit procedures or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and modify the further planned audit procedures accordingly (AU-C 315.32). For fraud, the auditor's risk assessment should be ongoing throughout the audit (AU-C 240.25). Accordingly, communications among the audit 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).

## Control Environment

- .45 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:
- 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; and
  - management should evaluate performance and hold individuals accountable for their internal control responsibilities. (Green Book)

The auditor should obtain and document an understanding of the control environment and the underlying principles. In connection with this understanding, the auditor should incorporate the elements of AU-C 315, which are discussed below.

- .46 As discussed in AU-C 315, control environment risk factors incorporate those charged with governance and management's attitude, awareness, and actions concerning the entity's internal control (AU-C 315.A78 and Green Book 1.01-5.08). These factors include:
- integrity, ethical values, and standards of conduct;
  - commitment to competence;
  - 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;
- participation by those charged with governance (AU-C 315.A79); and
- documentation of the internal control system.

.47 The auditor should obtain and document an understanding of the control environment sufficient to assess the risk of material misstatement and to plan the audit. As part of obtaining this understanding, the auditor should evaluate whether (1) management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior and (2) the strengths in the control environment collectively provide an appropriate foundation for the other components of internal control and whether those other components are not undermined by deficiencies in the control environment (AU-C 315.15). The auditor should evaluate the design of the control environment and determine whether it has been implemented. In doing this, 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.

- a. **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 through 1.05).
- b. **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 through 4.04). It is supplemented by effective human resource policies and practices, as discussed below.

- c. **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.
- d. **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 through 3.05).
- e. **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 through 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).
- f. **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 the performance of their assigned responsibilities by giving them the necessary resources (Green Book 4.05).

- g. **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 260.78, and controls over budget execution (budget controls) are addressed in more detail in FAM 300.
- h. **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.
- i. **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 through 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 (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.
- j. **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 through 3.12 and 12.02).
- k. **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 through 4.08).
- l. **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 through 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

- .48     Assesses the risks facing the entity as it seeks to achieve its objectives. This assessment provides the basis for developing appropriate risk responses. Management assesses the risks the entity faces from both external and internal sources. The underlying principles for this component are as follows:

- 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; and
- management should identify, analyze, and respond to significant changes that could impact the internal control system. (Green Book)

The auditor should obtain and document an understanding of the entity risk assessment and the underlying principles. In connection with this understanding, the auditor should incorporate the elements of AU-C 315, which are discussed below. This includes obtaining an understanding of whether the entity has a process for (a) identifying business risks relevant to financial reporting objectives, (b) estimating the significance of the risks, (c) assessing the likelihood of their occurrence, and (d) deciding about actions to address those risks as discussed in AU-C 315.16.

- .49     Entity risk assessment is an entity's process for identifying, analyzing, and responding to (1) risks relevant to achieving the objectives of reliable financial reporting (including safeguarding of assets) and compliance with laws (including those governing the use of budget authority), regulations, contracts, and grant agreements and (2) significant changes that could impact the internal control system. For example, the entity's risk assessment may address how the entity analyzes significant estimates recorded in the financial statements or how it

considers the possibility of unrecorded transactions (AU-C 315.A89). Risks may arise due to both internal and external circumstances, such as

- changes in the operating or statutory environment;
- new personnel who may have a different focus on internal control;
- the ability of management to override established controls;
- new or significantly changed 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, which may affect risks in preparing financial statements; or
- changes in economic conditions. (AU-C 315.A90)

- .50 The auditor should obtain and document an understanding of the entity's risk assessment process sufficient for assessing the risk of material misstatement and planning the audit. The auditor should evaluate the design of the entity's risk assessment process and determine whether it has been implemented. In doing this, the auditor should understand whether the entity has a process for (1) identifying risks relevant to the entity and its objectives of financial reporting (including safeguarding and its service organizations) and its compliance with budget and other laws, regulations, contracts, and grant agreements; (2) estimating the significance of the risks; (3) assessing the likelihood of their occurrence; and (4) deciding about actions to address those risks (AU-C 315.16 and Green Book 7.01 through 7.09 and 10.02). This also includes understanding whether management defines objectives clearly in specific and measurable terms to enable the design of internal control for related risks is 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).
- .51 If the entity has established a risk assessment process, the auditor should obtain an understanding of it and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor should evaluate whether an underlying risk existed that the auditor expects would have been identified by the entity's risk assessment process. If such a risk exists, the auditor should obtain an understanding of why that process failed to identify it and evaluate whether the process is appropriate to its circumstances or determine if a significant deficiency or material weakness exists in internal control regarding the entity's risk assessment process (AU-C 315.17).
- .52 If the entity has not established a risk assessment process or has an ad hoc process, the auditor should discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have

been addressed. The auditor should evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances or determine whether it represents a significant deficiency or material weakness in the entity's internal control (AU-C 315.18).

## Information and Communication Factors

- .53 The quality information management and personnel communicate and use 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:
- 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, and
  - management should externally communicate the necessary quality information to achieve the entity's objectives. (Green Book)

The auditor should obtain and document an understanding of information and communication and the underlying principles. In connection with this understanding, the auditor should incorporate the elements of AU-C 315, as discussed below.

As discussed in AU-C 315, the auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas: (a) the classes of transactions in the entity's operations that are significant to the financial statements; (b) the procedures within both information technology and manual systems by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements; (c) the related accounting records supporting information and specific accounts in the financial statements that are used to initiate, authorize, record, process, and report transactions, including correcting information and determining how information is transferred to the general ledger. The records may be in either manual or electronic form; (d) how the information system captures events and conditions, other than transactions, that are significant to the financial statements; (e) the financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and (f) controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions or adjustments (AU-C 315.19). See FAM 320 for discussion on understanding information systems.

Further, the auditor should obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including (a) communications between management and those charged with governance and (b) external communications, such as those with regulatory authorities (AU-C 315.20).

- .54 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 (See Green Book 14.02 through 14.06). 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 and 14.08). Laws and regulations may require entities to establish separate lines of communication, such as whistle-blower 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).

- .55 The auditor should obtain and document an understanding of the entity's communication process sufficient for assessing the risk of material misstatement and planning the audit. The auditor should evaluate the design of the entity's communication process and determine whether it has been implemented. In doing this, the auditor should obtain sufficient knowledge of the means the entity uses to communicate roles and responsibilities for, and significant matters relating to, financial reporting, including safeguarding of assets and compliance with laws (including those governing the use of budget authority), regulations, contracts, and grant agreements. This would also include communications between management and those charged with governance and external communications (AU-C 315.20). 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 (See Green Book 15.02 through 15.06 and 13.02).

## Monitoring Factors

- .56 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:
- management should establish and operate monitoring activities to monitor the internal control system and evaluate the results and
  - management should remediate identified internal control deficiencies on a timely basis. (Green Book)

The auditor should obtain and document an understanding of monitoring and the underlying principles. In connection with this understanding, the auditor should incorporate the elements of AU-C 315, which are discussed below.

As discussed in AU-C 315, the auditor should obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls (AU-C 315.23). The auditor should obtain an understanding of the sources of the information used in the entity's monitoring activities and the basis upon which management considers the information to be sufficiently reliable for the purpose (AU-C 315.25).

- .57 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 (see Green Book 16.02 and 16.03). Monitoring may include separate evaluations, such as FMFIA (OMB Circular No. A-123) work and IG or internal auditor work, or a combination of ongoing activities and separate evaluations. See FAM 260.65 through .70 for discussion of the FMFIA process. Ongoing monitoring is built into the entity's operations, 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 (see Green Book 16.04 through 16.09).
- .58 The auditor should obtain and document an understanding of the entity's monitoring process sufficient for assessing the risk of material misstatement and planning the audit. The auditor should evaluate the design of the entity's monitoring process and determine whether it has been implemented. By doing this, the auditor should gain sufficient knowledge of the major types of activities the entity uses to monitor internal control over financial reporting, including safeguarding and compliance with laws (including those governing the use of budget authority), regulations, contracts, and grant agreements, and how monitoring is used to initiate corrective actions.
- .59 If the entity has an internal audit function, the auditor should obtain an understanding of the nature of the internal audit function's responsibilities, how the internal audit function fits in the entity's organizational structure, and the activities performed or to be performed (AU-C 315.24). The internal audit function 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.)



- .60 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 (1) conducts audits and investigations relating to programs and operations; (2) provides leadership and coordination, including recommending policies for programs and operations; and (3) 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).
- .61 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 (see Green Book 17.01 through 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).

## Control Activities

- .62 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:
- 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. (Green Book)

The auditor should obtain and document an understanding of control activities and the underlying principles. In connection with this understanding, the auditor should incorporate the elements of AU-C 315, which are discussed below.

As discussed in AU-C 315, the auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor deems necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures that respond to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of

reconciling detailed records to the general ledger for material account balances (AU-C 315.21). In understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from information technology (AU-C 315.22). See FAM 340 for further discussion on identifying and understanding relevant control activities.

## **Information Systems' Effect on the Control Environment, Entity Risk Assessment, Communication, and Monitoring**

- .63 Information systems affect the effectiveness of control activities, the control environment, entity risk assessment, communication, and monitoring. 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.A60 through .A67 for further discussion of the effect of information systems on internal control.
- .64 The auditor should obtain and document an understanding of the control environment related to the entity's information system sufficient for assessing the risk of material misstatement and planning the audit. The auditor should evaluate the design of the control environment related to entity's information system and determine whether it responds to the entity's objectives and risks and has been implemented (Green Book 11.02). In doing this, the auditor should evaluate the following information system factors in making an overall assessment of the control environment, entity risk assessment, communication, and monitoring. An IS controls auditor may assist the auditor in considering these factors.
- a. **Management's attitudes and awareness with respect to information systems:** Management's interest in and awareness of information system 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 system 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 systems;
  - responding to previous recommendations or concerns;
  - quickly and effectively planning for, and responding to, information system processing crises; and
  - using reliable computer-generated information for key operating decisions.
- b. **Organization and structure of the information systems function:** The organizational structure of the information systems 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 systems. 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.

- c. **Clearly defined assignment of responsibilities and authority:** Appropriate assignment of responsibility according to typical information system functional areas can affect the control environment. Factors to consider include
- how the position of the Chief Information Officer fits into the organizational structure;
  - whether duties are appropriately segregated within the information systems 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 systems function is involved in major systems development decisions; and
  - the extent to which information system policies, standards, and procedures are documented, understood, followed, and enforced.
- d. **Management's ability to identify and to respond to potential risk:** Information system processing, 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 system 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<sup>6</sup>

- .65 If applicable to the entity, the auditor should obtain an understanding of the entity's FMFIA process and whether the process has been implemented. Based on this understanding, the auditor should determine whether the auditor's understanding of the FMFIA process affects the auditor's risk assessment.
- .66 OMB Circular No. A-123, Management's Responsibility for Enterprise Risk Management and Internal Control, provides guidance on improving the accountability and effectiveness of entity operations and programs by establishing, correcting, and reporting on internal control. The circular defines management's responsibilities related to internal control and the process for assessing the effectiveness of internal control. Entities are required to report on the adequacy and effectiveness of internal controls as described in the circular.

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<sup>6</sup>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 595A.

Management is to provide an assessment on the effectiveness of the entity's internal control over operations, reporting, and compliance.

- .67 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 FMFIA requirements.
- .68 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.
- 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 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.
  - 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.
  - Identify the entity's actions on previously reported deficiencies and examine its documentation that demonstrates the results/effectiveness of those actions.
  - Determine whether the audit finds different issues from those identified in the FMFIA process (if so, see FAM 580 for reporting on FMFIA).
- .69 The auditor should consider whether management procedures and supporting documentation are designed to (1) provide management with reasonable assurance that FMFIA objectives have been achieved and (2) meet OMB requirements. The auditor's consideration is based on the auditor's understanding of the procedures discussed in FAM 260.68 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;
- OMB audit guidance on FMFIA, including Circular No. A-123; and
- risk factors in FAM 295 B.19.

.70 The auditor should document the understanding of the FMFIA process and its implementation. Based on this understanding, the auditor should determine whether the auditor's understanding of the FMFIA process affects the auditor's risk assessment. The auditor should consider any material weaknesses identified in the FMFIA report in determining 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 related line items, accounts, and relevant assertions. FAM 360 discusses nonsampling control testing, and FAM 370 discusses the assessments of control risk and the risks of material misstatement.

### **Internal Control over Financial Reporting**

.71 Further, 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 GAO's *Standards for Internal Control in the Federal Government* (GAO-14-704G, September 2014), 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.

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 a risk assessment.
- Review documentation from the entity's prior assessments of internal control over financial reporting.
- Determine whether management coordinates its internal control over financial reporting review process with other reviews (e.g., FMFIA).

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.20.

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 IS controls, FAM 360 discusses nonsampling control testing, and FAM 370 discusses the assessments of control risk and the risks of material misstatement.

## **Federal Financial Management Improvement Act of 1996**

- .72 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, *Compliance with the Federal Financial Management Improvement Act* 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.
- .73 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. The entity may have used the OMB or Treasury FFMIA guidance for systems reviewed under FFMIA or other tools. The auditor generally should read this 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.
- .74 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 the potential risks of material misstatement to line items, accounts, and related assertions. 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**

- .75 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 entities to use NIST standards when performing certain functions. OMB reporting guidance for FISMA specifies the applicable NIST standards and other NIST publications to be used.
- .76 FISMA requires entities 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) 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. Entity IGs are also required to annually perform an independent evaluation of the effectiveness of its information security program. Entity management may rely on testing performed as part of the independent evaluation when making its own assessment.
- .77 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 for related line items, accounts, and relevant assertions. 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**

- .78 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 extent of correlation between information developed in the budget formulation process and the allotments and suballotments, if applicable, in the budget execution system.
- .79 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.



## **270 – Determine Likelihood of Effective IS Controls**

- .01 As discussed in FAM 240.11 through .16, when significant accounting applications include control activities, such as application and user controls, that are dependent on information system processing, the auditor should assess IS controls using an appropriate methodology. IS controls consist of those internal controls that are dependent on information system processing and include general controls, application controls, and user controls. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity's use of information systems and 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.
- .02 In the planning phase, the auditor should identify and document the general controls implemented at the entitywide, system, and application levels that help ensure the effective operation of application and user controls included in the significant accounting applications. 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. As discussed in FAM 240.12, general controls help ensure the proper operation of information systems by creating the environment for effective operation of application controls. The auditor may coordinate work done to meet the provisions of FISMA (44 U.S.C. 3551-3558) with work done as part of the financial statement audit. See FAM 295 J for a flowchart of steps for assessing IS controls during a financial statement audit. Also see FISCAM and other applicable guidance.

The procedures performed to determine the likelihood of effective IS controls build on those procedures performed to gain an understanding of the entity's operations, including the design of its internal controls, and assess the effects of information systems on inherent risk and the control environment, risk assessment, information and communication, and monitoring. As discussed in AU-C 315.13 through .25, the auditor should obtain an understanding of each of the five components of internal control—control environment, risk assessment, information and communication, monitoring, and control activities—sufficient for assessing the risks of material misstatement of the financial statements whether due to error or fraud, and for determining the nature, extent, and timing of further audit procedures. This understanding should include relevant information system aspects.

- .03 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.

If the auditor determines that a financial management system maintained by a service organization is significant, then the auditor should follow the guidance outlined in FAM 640.05 through .10

- .04 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.A68, 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.

- .05 If the general controls identified are not likely to be effective, the auditor should obtain a sufficient understanding of control risks arising from information systems 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.
- .06 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 due to 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.
- .07 As discussed in AU-C 315.31 and AU-C 315.A133 through .A136, in some circumstances, such as where a significant amount of information is electronically initiated, recorded, processed, and reported, it may not be possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. In such circumstances, IS controls should be tested to obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of the risks of material misstatement.

## **275 – Identify Relevant Operations Controls to Evaluate and Test**

- .01 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**

- .02 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.
- .03 The auditor should document the operations controls identified for testing, the procedures performed, and the results.
- .04 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 prepared by the entity;
  - understanding the cause of misstatements noted; or
  - observing activities during fieldwork.
- .05 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.

- .06 The auditor may identify specific 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; and
  - the auditor plans to rely upon this control during the audit; or
  - the auditor is required to test the control following OMB's 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.
- .07 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**

- .08 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 .21, 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, (1) the relevant general controls and the specific application level controls over the data and/or (2) the data in the report.

## **280 – Plan Other Audit Procedures**

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

### **Inquiries of Legal Counsel**

- .02 As discussed in AU-C 501.16, FAM 550.02, and FAM 1002, 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 legal representation letter is needed as part of a financial statement audit. The auditor should plan the following procedures, which are described in more detail in AU-C 501, for an appropriate time during the audit:
- making inquiries of entity management, which may include discussing their policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments;
  - obtaining a description and evaluation of all such matters existing as of the balance sheet date and through the date of management's response, which should be near the completion of the audit;
  - obtaining evidence regarding internal and external legal counsel used by the entity and matters handled;
  - reviewing legal expense accounts and invoices from external legal counsel (AU-C 501.16d); and
  - sending letters of audit inquiry to legal counsel—the auditor may limit the inquiry to matters that are considered individually or collectively material to the financial statements, provided the entity and the auditor have reached an understanding and agreement on the materiality level.

### **Management Representations**

- .03 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. For federal government audits, these representations include (1) the effectiveness of internal control over financial reporting; (2) compliance with laws, regulations, contracts, and grant agreements; (3) management's materiality thresholds for reporting, and (4) for CFO Act agencies, whether financial management systems comply substantially with FFMIA requirements. 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.

Additionally, a summary of uncorrected misstatements (including prior period misstatements that affect the current financial statements) aggregated by the auditor should be attached to the 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 taken as a whole, both individually and in the aggregate.

## **Related Party Relationships and Transactions<sup>1</sup>**

- .04 During the planning phase, the auditor should perform procedures to (1) obtain an understanding of the entity's related party relationships and transactions (see FAM 220.08), (2) consider the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions (see FAM 260.36), and (3) identify the risks of material misstatement (see FAM 260.39 and .43). The identity of the entity's related parties and other relevant information obtained about the related parties should be distributed to all members of the audit team (AU-C 550.18). Throughout the audit, audit team members should remain alert when inspecting records or documents for arrangements or other information that may indicate the existence of additional related party relationships or transactions (AU-C 550.16). Also see FAM 904 for additional procedures the auditor should perform and FAM 550 for concluding on related party relationships and transactions.

In addition to considering disclosure entities in the context of performing procedures for related party relationships and transactions noted above, 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)<sup>2</sup>:

- 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.

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<sup>1</sup>Such related party relationships and transactions may include, as defined by FASAB, disclosure entities, related parties, and public-private partnerships (FAM 904.03).

<sup>2</sup>Procedures related to disclosure entities do not apply to entities issuing financial statements in accordance with FASB accounting standards.

## Required Supplementary Information

- .05 Per U.S. GAAP and OMB Circular No. A-136, *Financial Reporting Requirements*, 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 basic financial statements, FASAB considers this information to be an essential part of financial reporting for placing the basic 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:

- 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.
- Compare the information for consistency with (also see FAM 520 for applying analytical procedures)
  - management's responses to the auditor's inquiries;
  - the basic financial statements;
  - other knowledge obtained during the audit of the basic financial statements; and
- If, on reading the information for the purpose of identifying material inconsistencies, the auditor becomes aware of an apparent material misstatement of fact, the auditor should discuss the matter with management.
- Obtain written representations from management as required in FAM 1001 (AU-C 730.05).

See FAM 550 for information on concluding on RSI and FAM 580 regarding how the auditor reports on the work performed in this area.

## Other Information Included with the Financial Statements

- .06 Per U.S. GAAP and OMB Circular No. A-136, *Financial Reporting Requirements*, certain information is to be included with the entity's financial statements and to be labeled as other information. Other information is financial and nonfinancial information (other than the basic financial statements, RSI, and auditor's report) that is included in a document containing audited financial statements and the auditor's report (AU-C 720.05).

For other information, the auditor should perform the following:

- Read the other information of which the auditor is aware in order to identify material inconsistencies, if any, with the audited financial statements (AU-C-720.06). If, on reading the other information for the purpose of identifying material inconsistencies, the auditor becomes aware of an apparent material misstatement of fact, the auditor should discuss the matter with management.
- Make appropriate arrangements with management or those charged with governance to obtain the other information prior to the report release date. If it is not possible to obtain all of the other information prior to the report release date, the auditor should read such other information as soon as practicable (AU-C 720.07).
- 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 720.08).
- If the auditor identifies any material inconsistencies between the other information and the audited financial statements or material misstatements of fact, refer to AU-C 720 for additional information.

See FAM 550 for information on concluding on other information and see FAM 580 regarding how the auditor reports on the work performed in this area.

## Supplementary Information

- .07 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.

## Opening Balances

- .08 AU-C 510 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 the opening balances, including disclosures that existed at the beginning of the period, contain misstatements that materially affect the current year's financial statements. See AU-C 510 for the specific requirements to be satisfied related to performing, concluding, and reporting on opening balances for initial audit engagements and reaudit engagements.

## Other Planning Issues

- .09 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.

- .10 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 visited. The auditor should determine whether to test the implementation of the recommendation or to repeat the finding.

### **Additional Audit Guidance**

- .11 During planning, the auditor also should apply the additional requirements in OMB financial reporting guidance for legal letters, management representation letters, and certain agreed-upon procedures. OMB audit guidance has specific dates by which interim and updated legal letters for specified entities are to be requested and received, specific formats for summarizing the information in the letters, and a list of specific officials to whom copies of the letters and summaries are to be forwarded. In addition, the guidance indicates that certain agreed-upon procedures are to be applied to entity payroll offices and that reports are to be submitted to OPM by a specific date.
- .12 During planning, the auditor should consider the implementation guidance in volume 2 of the FAM as applicable. Volume 2 includes areas such as Working with Others, FFMIA Guidance and AUP Guidance, Compliance, and Specific Substantive Testing Areas.

## **285 – Plan Locations to Visit**

- .01 Most federal 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 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 significant accounts and accounting systems and cycles/accounting applications. This understanding may be obtained centrally or in combination with visits to field locations, as appropriate. When planning locations to visit, the auditor should evaluate whether certain locations warrant more extensive testing than others, based on the following factors:
- a. **Materiality or significance of locations to the overall entity:** More material locations, particularly those individually generating transactions or account balances that exceed performance materiality, those with significant cycles/accounting applications, and/or those with significant information systems centers, may indicate the need for more extensive testing.
  - b. **The results, if location specific, of the preliminary analytical procedures applied during planning:** The auditor should follow up on unusual results, possibly including on-site testing at specific locations with unusual results.
  - c. **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.
  - d. **The auditor's 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 inherent risk is high generally warrant more extensive testing than those where inherent risk is low. In addition, the inherent risk may be different for different accounts and assertions at each location.
  - e. **The auditor's preliminary assessment of control risk, including the control environment, risk assessment, communication, and monitoring:** Locations at which control risk (particularly concerning the control environment, risk assessment, information and communication, and monitoring) is high warrant more extensive testing than those where control risk is low. In addition, at lower-risk locations, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the entity, provides the auditor with sufficient appropriate evidence.
  - f. **The auditor's assessment of the risk of material misstatement due to fraud:** Locations at which the auditor has assessed a greater 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.

- g. **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.
  - h. **The extent to which accounting records are centralized:** A high degree of centralization may enable the auditor to conduct the majority of work at the central location, with only limited work at other locations.
  - i. **The extent of uniformity of control systems (including IS controls) throughout the entity:** The number of locations visited 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 visit more locations than for those entities using centrally developed systems that cannot be changed locally.
  - j. **The extent of work performed by other auditors:** The auditor may use work performed by other auditors to reduce or eliminate tests at selected locations or to assist in tests of locations not selected. (See FAM 620, 630, 640, and 645.)
  - k. **Special reporting or entity requirements:** The auditor should visit sufficient locations to meet special needs, such as the need for separate-location reports.
  - l. **Testing controls at least once every 3 years:** The auditor should test controls that are designed and implemented effectively at least once in every third year in an annual audit (AU-C 330.14b). As time elapses from the time a control is tested, audit evidence provided in the current audit period about the operating effectiveness of a control tested in a prior period becomes less relevant and reliable. The auditor generally should coordinate locations selected to visit with this control testing requirement. (Note: If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor should test controls in the current audit. See AU-C 330.14a.)
- .02 The auditor should plan the general nature of audit procedures to be performed at each location. The extent of testing may vary between locations, depending on tolerable misstatement, control risk, risk of material misstatement, and other factors. Using common audit programs, audit documentation formats, and indexes for the various locations visited makes it easier to plan, review the audit documentation, and combine the results of all locations or funds to improve effectiveness and efficiency. The auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.
- .03 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.
- .04 One approach to stratifying locations, selecting locations to visit, and selecting individual samples for multiple-location audits is presented in FAM 295 C. This method assumes that increased testing is not required at any location because of the factors in FAM 285.01. Other methods of selecting locations for on-site

testing may be used with the approval of the reviewer. For example, selecting fewer locations but more items to test at each of those locations may be appropriate in some instances. Although other methods generally involve more testing than the method described in FAM 295 C, the costs of performing additional work at fewer locations may be lower.

- .05 The auditor should document the planned locations to visit in the audit strategy, audit plans, or equivalent documents.

## **290 – Documentation**

- .01 As discussed in 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 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.

- .02 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 FAM 290.03 through .10 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.
- .03 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.
- .04 In the **entity profile** or an equivalent document, the auditor should document the information useful for understanding the entity and its operations (FAM 220). The auditor should document key elements of the understanding obtained regarding each of the aspects of the entity and its environment identified in FAM 220.02 to assess the risks of material misstatement of the financial statements, including the sources of information from which the understanding was obtained (AU-C 315.33.b). However, the auditor generally should document internal control separately, as discussed below in FAM 290.06 and in FAM 390. The auditor may include the information in the entity profile in the audit strategy.
- In this profile the auditor generally should briefly document such elements as the entity's origin, history, mission, size, locations, organization, and key members of management; the legal and regulatory framework; the applicable financial reporting framework and external and internal factors affecting operations; use of information systems; and accounting policies. 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.

- .05 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 260). The auditor should document these discussions, including how and when the discussion occurred, the subject matter discussed, the audit team members who participated, and significant decisions reached (AU-C 240.43a and 315.33a).
- .06 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; and (4) ascertain the nature, timing, and extent of resources necessary to perform the engagement. The audit strategy should include or refer to information on the following areas:
- a. **Conclusions reached regarding acceptance and continuance of the client relationship and audit engagement (FAM 215)**
  - b. **Results of the prior year's audit**
  - c. **Accounting and auditing standards**
    - Accounting standards, including whether the financial reporting framework to be applied in the preparation of the financial statements (e.g., U.S. GAAP) is acceptable (FAM 215).
    - Auditing standards and guidance applicable to the engagement (e.g., U.S. GAGAS), including any
      - auditing interpretations and exhibits of GAAS (see AU-C sections),
      - AICPA audit and accounting guides and statements of position (see AU-C appendix D), and
      - other auditing publications (see AU-C appendix F) (AU-C 200.27).
  - d. **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.
- e. **Amount and basis for materiality determination [materiality for the financial statements taken as a whole, performance materiality, tolerable misstatement, clearly trivial, FMFIA, management representation letter, and legal letter] and any revisions to materiality as the audit progresses (FAM 230).** This should include, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures (AU-C 320.14).
- f. **Methodology used to assess IS controls (FAM 240):** The auditor also should document the basis for believing that the methodology is appropriate. As discussed in FAM 240.16, GAO auditors should use the 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.
- g. **Significant provisions of laws and regulations (FAM 245).**
- h. **Approach for identifying and testing significant provisions of contracts and grant agreements (FAM 245).**
- i. **Relevant budget restrictions (FAM 250).**
- j. **Level of audit assurance (FAM 260):** The auditor should document the overall level of audit assurance and the justification for the level used. If the level of audit assurance chosen is 95 percent, the auditor may reference the FAM.
- k. **Assessment of inherent risk and the risk factors considered in the assessment (FAM 260).**
- l. **Understanding of the design of each component of internal control—control environment, entity risk assessment, information and communication, and monitoring—to assess the risks of material misstatement of the financial statements, including whether an ineffective control environment precludes the effectiveness of specific control activities (FAM 260):** The auditor should document key elements of the understanding of the design of the control environment, entity's risk assessment, information and communication, and monitoring to assess the risks of material misstatement. In addition, the auditor should document the sources of information from which the understanding was obtained, procedures performed, and conclusions reached on whether the component was implemented as designed (AU-C 315.33.b.). For CFO Act agencies, the auditor generally should document the entity's basis for its determination of substantial compliance of its financial management systems with FMFIA requirements. (FAM 390 discusses documentation of the auditor's understanding of the design of control activities for assessing the risks of material misstatement.)

- m. **Risk of material misstatement (FAM 260):** The auditor should document the identified and assessed risks of material misstatement at the financial statement level and at the relevant assertion level (AU-C 315.33.c).
- **Risks of material misstatement due to error (FAM 260):** The auditor should document risks of material misstatement due to error identified at the financial statement level (those that relate pervasively to the financial statements as a whole) and the auditor's overall responses. The auditor should also document risks of material misstatement due to error assessed at the relevant assertion level and should link them with specific line items and accounts. For each risk identified, the auditor should document the (1) nature and extent of the risk; (2) condition(s) that gave rise to that risk; and (3) specific cycles, accounts, line items, and related assertions affected (if not pervasive). The auditor should also determine which of the risks identified require special audit consideration (significant risks). (FAM 490 discusses documentation of substantive audit procedures to respond to the risks of material misstatement.)
  - **Risks of material misstatement due to fraud (FAM 260):** The auditor should document risks of material misstatement due to fraud, which are considered significant risks, identified at the financial statement level and at the assertion level for specific line items and accounts (AU-C 240.43.b). (Also see FAM 290.09.)
    - specific fraud risks (categorized by type of misstatement and by incentive/pressure, opportunity, and attitude/rationalization) that were identified and the assessment of those risks;
    - if the auditor concludes that no risks of material misstatement due to fraud relating to revenue recognition exists, the reasons supporting that conclusion;
    - consideration of the risk of management override of controls; and
    - the auditor's response to the assessed fraud risks—the overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing, and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level (AU-C 240.44.a). (See FAM 590.)
- n. **Significant risks and risks for which substantive procedures alone do not provide sufficient appropriate audit evidence (FAM 260):** The auditor should document the risks identified and related controls about which the auditor has obtained an understanding (AU-C 315.33.d), as described in FAM 260.43.
- o. **Effects of information systems (FAM 270):** The auditor should document, either separately or as part of the assessments above,
- a basic understanding of the design of IS controls relevant to the entity's financial management, including the significance of information system processing to the entity, and whether the controls have been implemented as designed (FAM 220);



- the IS controls included in the significant accounting applications, including the general controls implemented at the entitywide, system, and application levels that help ensure the proper operation of the application and user controls (FAM 240);
- the inherent risks arising from information systems (FAM 260.11);
- the impact of information systems on the design of the control environment, entity's risk assessment, information and communication, and monitoring (FAM 260.63 through .64); and
- tentative conclusions on the likelihood that IS controls are effective (FAM 270).

Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity's use of information systems and in planning, directing, or performing audit procedures related to assessing IS controls. 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.

- p. **Operations controls to be tested, if any (FAM 275).**
- q. **Other planned audit procedures (FAM 280).**
- r. **Planned interim testing (FAM 295 D):** This information includes the basis for concluding that the use of interim testing is appropriate.
- s. **Locations to be visited (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 sample is selected, particularly for a statistical sample); and
  - other procedures applied.
- t. **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 220.16) and

- the nature, timing, and extent of direction and supervision of engagement team members and review of their work (AU-C 300.11).
- u. **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.
- v. **Audit timing, including milestones and the estimated date of the auditor's report.**
- w. **Extent of assistance from entity personnel.**
- x. **Parties identified as those charged with governance (FAM 215).**
- .07 The **cycle matrix** or equivalent links each of the entity's accounts in the trial balance to a cycle, an accounting application, and a financial statement line item (FAM 240.05).
- .08 The **LIRA** or equivalent contains the audit plan for each significant line item and identifies significant line items, assertions, and cycles/accounting applications (FAM 235 and FAM 240) and the related risks of material misstatement at the relevant assertion level, as discussed in AU-C 315.26 through .27. The auditor should also summarize and document the specific risks of material misstatement, other than pervasive risks, including the inherent, fraud, and control risk factors, for use in determining the nature, extent, and timing of audit procedures.
- .09 **Fraud risk assessments (FAM 260):** This information includes
  - the brainstorming meeting(s) about potential fraud risks (see FAM 290.05);
  - the procedures performed to obtain information about, identify, and assess fraud risks;
  - any other significant procedures performed or other significant matters related to the auditor's consideration of fraud (and any significant abuse);
  - the effect of fraud risk on the audit strategy; and
  - changes to fraud risk assessment during the audit.
- .10 As discussed in AU-C 300.09, the auditor should develop an audit plan that includes a description of the following items. The related FAM documentation is in parentheses.
  - The nature and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement (AU-C 300.09a) (included in portions of the audit strategy, LIRA, and SCE worksheets or equivalent documents prepared following the FAM).
  - A description of the nature, extent, and timing of planned further audit procedures at the relevant assertion level for each material class of transactions, account balances, and disclosure (AU-C 300.09b). The plan for further audit procedures reflects the auditor's decision of whether to test the

operating effectiveness of controls, and the nature, extent, and timing of planned substantive procedures (included in the LIRA and related specific audit plans for each specific area of the audit prepared following the FAM).

- A description of other planned audit procedures to be carried out for the engagement to comply with GAGAS, including U.S. GAAS for these audits (AU-C 300.09c). For example, including an overview in the audit strategy with details in related audit plans for specific areas of the audit.

The audit completion checklist (see FAM 1003) also summarizes documentation of auditor compliance with GAGAS and the FAM.

- .11 Other auditor considerations may 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 deviate from a policy or 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 deviations and the alternative procedures performed to achieve the requirement.
- .12 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 federal 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 audit 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. The auditor may discuss these matters with entity management as the conditions are identified to inform them timely and to provide assurance that information is accurate and complete, rather than waiting until the exit conference.

## **295 A – Potential Inherent Risk Conditions**

- .01 The specific conditions listed below may indicate the presence of inherent risks, some of which may also be fraud risks. 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 considering each of the inherent risk factors described in FAM 260.10 and the fraud risk factors described in FAM 260.18 relating to industry conditions, operating conditions, financial stability, and susceptibility of assets to misappropriation. The auditor should evaluate any other relevant factors and conditions.
- .02 **Nature of the Entity's Programs and Operations**
- a. Programs are significantly affected by new/changing laws and regulations, economic factors, and/or environmental factors.
  - b. Contentious or difficult accounting issues are associated with the administration of a significant program(s).
  - c. Major uncertainties or contingencies, including long-term commitments, relate to a particular program(s).
  - d. 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.
  - e. Programs that are being phased out (being eliminated within 1 or 2 years) lack adequate resources, personnel motivation, and/or interest.
  - f. Significant programs have a history of improper administration, affecting operating activities.
  - g. 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.
  - h. 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.
  - i. Management faces significant pressure to "use or lose" appropriated funds in order to sustain future funding levels.
  - j. Partisan politics between competing political parties or factions or constituent groups create conflict and a lack of stability within the entity or its programs.
  - k. Unusually rapid growth occurs in a program.
  - l. Economic conditions are deteriorating among the group served by the entity.
  - m. Responsibilities for significant sensitive assets or proprietary information (national security, tax, health, etc.).
- .03 **History of Significant Audit Adjustments**
- The underlying cause of significant audit adjustments continues to exist.

**.04 Nature of Material Transactions and Accounts**

- a. New types of transactions exist.
- b. Significant related and/or third-party transactions exist.
- c. 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.
- d. Accounts have complex underlying calculations or accounting principles.
- e. Accounts where underlying activities, transactions, or events are operating under severe time constraints.
- f. Significant interagency transactions or revenue sources create incentives to shift costs or otherwise manipulate accounting transactions.
- g. Accounts where activities, transactions, or events involve the handling of unusually large cash receipts, cash payments, or wire transfers.
- h. 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).
- i. Assets such as food stamps, benefits vouchers, commodities, supplies, or materials are easily converted to cash.
- j. Assets such as cars, computers, and telephones are susceptible to personal, nonprogram/nongovernment use.
- k. Many payments are sent to post office boxes.
- l. 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’s Risk Assessment, Communication, and Monitoring Deficiencies**

- .01 The specific conditions listed below may indicate risks of material misstatement because of control environment, entity’s risk assessment, communication, and monitoring deficiencies as well as potential fraud risk. The auditor may use this section when separately evaluating the design of the control environment, entity’s risk assessment, communication, and monitoring components described in FAM 260.45- through .61.<sup>1</sup> The auditor also may evaluate any other relevant factors and conditions. Appendix B of AU-C 315 provides additional guidance for understanding these components of internal control. The auditor may also refer to GAO’s *Standards for Internal Control in the Federal Government* (GAO-14-704G, September 2014) for additional and more detailed examples of internal control components. The auditor may evaluate these factors for the entire entity or by location.

### **Control Environment**

- .02 **Communication and Enforcement of Integrity and Ethical Values (Green Book 1.01 through 1.10)**
- a. 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.<sup>2</sup>
  - b. 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.
  - c. Employees do not understand what behavior is acceptable or unacceptable, or what to do if they encounter improper behavior.
  - d. Management covers up bad news rather than making full disclosure as quickly as possible.
  - e. Management does not quickly address signs that problems exist.
  - f. Management and employees feel pressure to cut corners or not follow established controls.
  - g. High decentralization leaves top management unaware of actions taken at lower organizational levels and thereby reduces the chances of management detecting errors and fraud.

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<sup>1</sup>These five components are discussed in *Standards for Internal Control in the Federal Government* (GAO-14-704G, September 2014) and in FAM 260.09 and FAM 340.

<sup>2</sup>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 management’s design, implementation, and operation of an internal control system and the entity’s financial reporting process. Accordingly, for these purposes, those charged with governance are considered part of the entity’s internal control. For a federal entity, this may be the members of a board or commission, an audit committee, the secretary of a cabinet-level department, or senior executive and financial managers responsible for the entity.

- h. 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).
- i. Penalties for improper behavior are insignificant or unpublicized and thus lose their value as deterrents.
- j. 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.
- k. Management and employees feel pressure to meet performance targets or deadlines that are unrealistic.
- l. Management is under undue pressure from the administration to attain an unmodified opinion on the financial statements, despite significant internal control deficiencies.
- m. 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.
- n. Management does not respond to internal and external auditors' recommendations to strengthen internal control.
- o. Management has strained relationships with the IG and/or its current or predecessor external auditors.
- p. Management does not encourage and consider employee suggestions.

**.03 Commitment to Competence (Green Book 4.01 through 4.04)**

- a. Management has not analyzed jobs to determine the knowledge and skills needed.
- b. Employees do not seem to have the knowledge and skills they should have to do their jobs, based on the level of judgment necessary.
- c. Supervision of employees does not compensate for lack of knowledge and skills in their specific jobs.
- d. Inexperienced and/or incompetent accounting personnel are responsible for transaction processing.
- e. The number of supervisors is inadequate or supervisors are inaccessible.
- f. Key financial staff members have excessive workloads.

**.04 Management's Philosophy and Operating Style (Green Book 1.02 through 1.05)**

- a. Management lacks concern about internal control and the environment in which specific controls function.
- b. Management demonstrates an aggressive approach to risk taking.
- c. 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.

- d. Management has a history of completing significant or unusual transactions near year-end, including transactions with related parties.
- e. Management makes numerous adjusting journal entries, especially at year-end.
- f. The process for preparing the financial statements is complex and includes many reclassifications and last-minute changes.
- g. Management is reluctant to (1) consult auditors/consultants on accounting issues, (2) adjust the financial statements for misstatements, or (3) make appropriate disclosures.
- h. Management displays a significant disregard for regulatory, legal, or oversight requirements or for IG, GAO, congressional authorities, or others charged with governance.
- i. Top-level management lacks the financial experience/background necessary for the positions held.
- j. Management is slow to respond to crisis situations in either operating or financial areas.
- k. Management uses unreliable and inaccurate information to make business decisions.
- l. Unexpected reorganization or replacement of management staff or consultants occurs frequently.
- m. Management and personnel in key areas (such as accounting, information systems, and internal auditing) have a high turnover.
- n. Individual members of top management are unusually closely identified with specific major projects.
- o. Management has publicly disclosed overly optimistic information on performance of programs and activities.
- p. Financial estimates consistently prove to be significantly overstated or understated.
- q. Obtaining adequate audit evidence is difficult due to a lack of documentation and evasive or unreasonable responses to inquiries.
- r. Financial arrangements/transactions are unduly complex.
- s. There is a lack of adequate interaction between senior management and operating management, particularly those in geographically dispersed locations.
- t. 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.



- u. Management is motivated to engage in fraudulent financial reporting because of substantial political pressure that creates undue concern about reporting positive financial accomplishments.
- v. 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.
- w. 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 fund-raiser).
- x. Management has significant grantee, cooperative agreement, or contractor relationships for which there appears to be no clear programmatic or governmental justification.
- y. Management appears more concerned with an unmodified opinion on the financial statements than fixing significant deficiencies in its systems.
- z. Management has difficulty meeting reporting deadlines.

**.05 Organizational Structure (Green Book 3.02 through 3.05)**

- a. 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 federal entity system),
  - federal decentralized (managed and controlled on a day-to-day basis by federal entity 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).
- b. The structure inhibits segregation of duties for initiating transactions, recording transactions, and maintaining custody over assets.
- c. Management has difficulty determining the organization or individual(s) that control(s) the entity, parts of the entity, or particular programs.
- d. Recent changes in the management structure disrupt the organization.
- e. Operational responsibilities do not coincide with the divisional structure.
- f. Delegation of responsibility and authority is inappropriate.
- g. A lack of definition and understanding of delegated authority and responsibility exists at all levels of the organization.
- h. Policies and procedures are established at inappropriate levels.
- i. A high degree of manual activity or spreadsheet use is required in capturing, processing, and summarizing data to prepare financial statements.
- j. A single person or a small group dominates activities.

- k. Entity officials could obtain financial or other benefits based on decisions made or actions taken in an official capacity.

**.06 Assignment of Authority and Responsibility (Green Book 3.06 through 3.08)**

- a. 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.
- b. Appropriate control-related standards and procedures are lacking.
- c. 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.
- d. Delegated authority is inappropriate in relation to the assigned responsibilities.
- e. An appropriate system of authorization and approval of transactions (for example, in purchasing, grants, and federal financial assistance) is lacking.
- f. Policies regarding physical safeguards over cash, investments, inventory, and fixed assets are inadequate.

**.07 Human Resource Policies and Practices (Green Book 4.05)**

- a. Human resource policies for hiring and retaining capable people are inadequate.
- b. Policies and procedures for hiring, promoting, transferring, retiring, and terminating personnel are inadequate.
- c. Training programs do not adequately offer employees the opportunity to improve their performance or encourage their advancement.
- d. Written job descriptions and reference manuals are inadequate or inadequately maintained.
- e. Communication of human resource policies and procedures at field locations is inadequate.
- f. Policies on employee supervision are inappropriate or obsolete.
- g. Management does not take remedial actions in response to departures from approved policies and procedures.
- h. Employee promotion criteria and performance evaluations are inadequate in relation to the code of conduct.
- i. Management does not adequately screen job applicants who will have access to assets susceptible to misappropriation.
- j. Training regarding controls over payments to others, such as those for benefits, grants, and federal financial assistance, is inadequate.
- k. Employees performing key control functions do not take vacations.
- l. Management does not reassign work of key employees on vacation.

**.08 Management’s Control Methods over Budget Formulation and Execution**

- a. Management provides little or no guidance material and instructions to those preparing the budget information.
- b. Management and employees do not understand the budget review, approval, and revision processes.
- c. Management demonstrates little concern for reliable budget information.
- d. Management participation in directing and reviewing the budget process is inadequate.
- e. Management is not involved in determining when, how much, and for what purpose obligations and outlays can be made.
- f. Management has not developed adequate planning and reporting systems that set forth management’s plans and the results of actual performance.
- g. 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.
- h. The entity has reported noncompliance, including violations of the Antideficiency Act, and purpose, time, or other budget-related restrictions.

**.09 Management’s Control Methods over Compliance with Laws, Regulations, Contracts, and Grant Agreements**

- a. Management is unaware of the applicable laws, regulations, contracts, and grant agreements and potential problems.
- b. A mechanism to inform management of the existence of illegal acts does not exist.
- c. Management neglects to react to identified instances of noncompliance with laws, regulations, contracts, and grant agreements.
- d. Management is reluctant to discuss its approach toward compliance and the reasonableness of that approach.
- e. Recurring public complaints have been received through “hotline” allegations.
- f. FMFIA reports; congressional reports; consultants’ reports; and prior audits/evaluations by GAO, the IG, internal auditor, or others disclose repeated instances of noncompliance or compliance control deficiencies.
- g. Management is reluctant to provide evidential matter necessary to evaluate whether noncompliance with laws, regulations, contracts, and grant agreements has occurred.
- h. Management is not responsive to changes in legislative or regulatory bodies’ requirements.
- i. Policies and procedures for complying with applicable laws, regulations, contracts, and grant agreements are weak.
- j. Policies on matters such as acceptable business practices, conflicts of interest, and codes of conduct are weak.

k. Management does not have an effective legal counsel.

.10 **Participation by Those Charged with Governance (Green Book 2.02, 2.05, and 2.06)**

a. Those charged with governance demonstrate little concern about controls and how and when management addresses internal and external auditors' recommendations.

b. Those charged with governance have little involvement in and provide little scrutiny of activities.

c. Little interaction occurs between those charged with governance and the IG and internal and external auditors.

d. Those charged with governance demonstrate little concern for compliance with applicable laws, regulations, contracts, and grant agreements.

.11 **Succession and Contingency Plans and Preparation (Green Book 4.06 through 4.08)**

a. Management does not have defined succession and contingency plans for key roles.

b. Management's succession plan does not define key roles.

c. Management has not chosen succession candidates.

d. Management does not provide training to succession candidates before they assume the key roles.

e. 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.

f. Management has not defined contingency plans for assigning responsibilities if a key role in the entity is vacated.

.12 **Enforce Accountability and Consider Excessive Pressure (Green Book 5.01 through 5.08)**

a. Management does not enforce accountability of individuals performing their internal control responsibilities.

b. Management does not have performance appraisals or provide disciplinary actions.

c. Management provides incentives that are not aligned with the entity's standards of conduct.

d. Management does not hold service organizations accountable for their assigned internal control responsibilities.

e. 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.

- f. Management does not take corrective actions to enforce accountability for internal control in the entity.
- g. Management does not adjust excessive pressures on personnel in the entity.
- h. Management does not evaluate pressure on personnel to help personnel fulfill their assigned responsibilities in accordance with the entity's standards of conduct.

## **Entity's Risk Assessment Process**

### **.13 Defining Objectives (Green Book 6.02 through 6.07)**

- a. Management has not defined or communicated its overall objectives to employees or those charged with governance, such as oversight committees.
- b. Management does not have a strategic plan, or the strategic plan is not consistent with the entity's objectives.
- c. The strategic plan does not address high-level resource allocations and priorities.
- d. The strategic plan, budgets, and/or objectives are inconsistent.
- e. Management has not defined activity-level objectives for all significant activities, or the objectives are inconsistent with each other or with the overall objectives.
- f. Objectives do not include measurement criteria.

### **.14 Identifying, Analyzing, and Responding to Risks (Green Book 7.01 through 7.09)**

- a. Management does not have a formal risk assessment process.
- b. 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.A143, appendix B, 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, business models, or products; (7) restructuring or reorganization; (8) expanded or new foreign operations; and (9) new accounting pronouncements.
- c. 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 with applicable laws, regulations, contracts, and grant agreements.
- d. Management has not adequately identified risks to the entity's ability to prevent and detect fraud.
- e. 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.

- f. 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).
  - g. 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.
  - h. Once risks are identified and analyzed, management has not adequately designed specific actions to respond to the risks.
- .15 **Identifying, Analyzing, and Responding to Significant Changes (Green Book 9.01 through 9.05)**
  - a. The mechanisms for identifying and communicating events, activities, and conditions that affect operations or financial reporting objectives are insufficient.
  - b. Accounting systems and/or information systems are not modified in response to changing conditions.
  - c. No consideration is given to designing new or alternative controls in response to changing conditions.
  - d. Management is unresponsive to changing conditions.

## Communication

- .16 **Internal Communication (Green Book 14.01 through 14.08)**
  - a. The system for communicating policies and procedures is ineffective.
  - b. Formal or informal job descriptions do not adequately delineate specific duties, responsibilities, reporting relationships, and constraints.
  - c. Channels of communication for reporting suspected improprieties are inappropriate.
  - d. Management fails to display and communicate an appropriate attitude regarding internal control.
  - e. 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.
  - f. Management is not receptive to employee suggestions of ways to enhance productivity and quality or control.
  - g. Communication across the organization (for example, between procurement and program activities) is inadequate to enable staff members to discharge their responsibilities effectively.
- .17 **External Communication (Green Book 15.01 through 15.09)**
  - a. 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.

- b. The entity's website is not used effectively as a communication tool.
- c. Outside parties have not been made aware of the entity's ethical standards.
- d. Management does not appropriately follow up on information received in communications from program service recipients, vendors, regulators, or other external parties.
- e. Management has not established an open two-way line of communication with external parties to allow quality information to be sent and received.

## Monitoring of Controls

### .18 Ongoing Monitoring (Green Book 16.04 through 16.08)

- a. Management is not sufficiently involved in reviewing the entity's performance or its controls.
- b. Management control methods are inadequate for investigating unusual or exceptional situations and for taking appropriate and timely corrective action.
- c. The entity does not have an effective hotline for reporting fraud, violations of laws and regulations, and control deficiencies.
- d. The entity does not have an effective internal audit function.
- e. 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.
- f. Management does not review whether periodic comparisons of amounts recorded in the accounting system with physical assets are performed on a timely basis and whether any differences are resolved timely.
- g. Management does not monitor whether reviews to prevent large numbers of duplicate payments and other improper payments are performed on a timely basis.
- h. Management does not effectively monitor that policies for developing and modifying accounting systems and control activities are reviewed on systematic basis to obtain reasonable assurance of operating effectiveness.
- i. 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.
- j. 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.

### .19 Separate Evaluations under FMFIA, OMB Circular No. A-123, and FFMIA

- a. Management displays a disregard for complying with the FMFIA and OMB Circular No. A-123 process, reports, results, and follow-up.
- b. Management displays a disregard for complying with or a combative attitude toward the FFMIA process, reporting, results, and follow-up.

- c. Employees without appropriate skills manage or perform FMFIA and OMB Circular No. A-123 reviews and FFMIA assessments.
- d. Management did not establish an organizational structure to effectively implement, direct, and oversee the assessment process, including FFMIA assessments. OMB Circular No. A-123 suggests 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.
- e. Management did not effectively evaluate controls at the entity level nor consider the components of internal control, as defined in OMB Circular No. A-123 or GAO’s Green Book, or the requirements of FFMIA.
- f. Auditors note deficiencies that were not included in FMFIA and FFMIA reports.

**.20 Management’s Assessment of Internal Control over Financial Reporting**

- a. 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 and key processes, controls, and/or transactions.
- b. Management did not adequately evaluate and document the key processes and controls, including documentation of decisions on determining the scope, materiality, testing methodology, and other significant decisions related to this assessment.
- c. Management did not use a reasonable approach to determine what, when, where, and how to test the key controls, and the tests and results were not properly documented.
- d. Management did not use the results of its testing to support its conclusion on whether internal controls over financial reporting were designed, implemented, and operating effectively.
- e. Management’s assurance statement did not appropriately describe any scope limitation and was not consistent with the evidence gathered during the testing process, including information gathered during the financial statement audit.
- f. 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.
- g. Auditors note deficiencies that were not included in management’s assessment of internal control over financial reporting.

**.21 Reporting Deficiencies (Green Book 17.02 through 17.04)**

- a. 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.
- b. 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.



- c. Management does not correct deficiencies timely.
- d. Management does not investigate underlying causes of problems.
- e. Management does not follow up to determine whether the necessary corrective action has been taken.

**.22 The Effectiveness of Other Auditors<sup>3</sup>**

- a. Auditors are responsible for making operating decisions or for controlling other original accounting work subject to audit.
- b. Audit management personnel are inexperienced for the tasks assigned.
- c. Auditors have minimal training, including little or no participation in formal courses and seminars and inadequate on-the-job training.
- d. Auditors have inadequate resources to conduct audits and investigations effectively.
- e. Audits are not focused on areas of highest exposure to the entity.
- f. Standards against which the auditor's work is measured are minimal or nonexistent.
- g. Performance reviews of audit staff are nonexistent or irregular.
- h. 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.
- i. 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.
- j. Audit documentation, such as audit strategy, audit plans/procedures, evidence of work performed, and support for audit findings, is incomplete.
- k. 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.
- l. Audit coverage over payments made by others, such as state or local governments, for benefits, grants, and federal financial assistance is inadequate.
- m. The auditor does not adequately review IS controls, including general and application controls.
- n. The auditor does not use appropriate tools, such as audit software and sampling.
- o. The audit organization does not have an adequate quality control system, including monitoring.

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<sup>3</sup>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.

- p. The audit organization does not have a peer review every 3 years.

## **295 C – An Approach for Multiple-Location Audits**

- .01 This section provides one approach for stratifying the locations and selecting the 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 specific risks of material misstatement (inherent or control risks). Other methods of selecting locations for on-site testing may be used with the approval of the reviewer. The auditor should consult with an audit sampling specialist when selecting locations.

### **Stratifying the Locations**

- .02 Unless the auditor uses a 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 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 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.
- .03 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

- .04 The auditor may select locations for on-site testing using one of the following methods for each stratum:
- MUS or classical variables sampling method using a multistage approach.
  - Another sampling method the auditor expects will be representative. The auditor should consult with an audit sampling specialist if classical variables sampling or another representative sampling method is used.
  - Nonrepresentative (nonsampling) selection method when the auditor determines that it is effective to select locations on a nonrepresentative basis and to apply substantive analytical procedures and/or other substantive tests to locations that are not tested on-site.

These methods are described in more detail in FAM 480.

- .05 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 size <sup>a</sup> | Actual number of locations tested <sup>b</sup> |
|--------------|---------------------|----------------------|--|--|
| Top          | 5                   | \$70,000,000         | 70   | 5  |
| Intermediate | 85                  | 29,000,000           | 29   | 29   |
| Bottom       | 10                  | 1,000,000            | 1  | 1  |
| <b>Total</b> | <b>100</b>          | <b>\$100,000,000</b> | <b>100</b>                                       | <b>35</b>                                      |

<sup>a</sup>The preliminary estimate of sample size is computed by dividing the total balance by the sampling interval of \$1,000,000. See FAM 400 for additional information concerning sampling.

<sup>b</sup>The 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

- .06 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 E.

- .07 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.

When nonrepresentative selection is used, the auditor should apply appropriate substantive analytical procedures and/or other substantive procedures for locations not tested on-site, unless those locations are immaterial in total. 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 on-site testing.

- .08 In evaluating the result of a sample, the auditor should estimate the effects, both quantitative and qualitative, on the financial statements taken as a whole of any misstatements noted, as discussed in FAM 480 and FAM 540. In visiting selected locations, in addition to the issues concerning evaluation of samples in those sections, the auditor, using professional judgment, generally should apply the following additional procedures upon finding misstatements or control deviations:
- a. Determine if apparent misstatements are, in fact, misstatements that have not been corrected at some level in the entity.
  - b. Ask management to identify the cause of the misstatements and whether similar misstatements are likely to have occurred at locations not visited.
  - c. Assess management's identification of cause.
  - d. Determine whether the misstatements indicate that there is a control deficiency. If so, determine whether the control deficiency applies only to the location visited 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.
  - e. Obtain evidence to test management's evaluation of whether the same or similar types of misstatement exist at other locations, including locations not tested on-site. 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 misstatement exists in other than a similar proportion throughout the entity. If such evidence exists and is appropriate and sufficient, the auditor generally should obtain evidence of the incidence rate and determine the effect on the entity. If no such evidence exists, the auditor should project the misstatement to the financial statements in determining the misstatement. The audit sampling specialist should review these projections.
- .09 In a nonrepresentative selection, the auditor generally should evaluate the possible effects of misstatements on locations not visited and determine whether to perform additional audit procedures. Because the selection is not representative, the misstatements cannot be projected to the entity as a whole.

- .10 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**

- .01 The auditor may decide to perform significant **substantive** tests of line items/accounts 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/accounts.) If the auditor performs interim tests, the auditor should also apply further substantive procedures or 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 period end.<sup>1</sup>
- .02 Because evidence obtained as of the year-end provides more assurance than evidence obtained as of an interim date, risk of material misstatement generally increases as the length of the roll-forward period increases. The auditor should evaluate the risk of material misstatement (inherent, control, and fraud risk) in determining whether substantive or 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.
- Although it is not necessary to obtain audit evidence about the operating effectiveness of controls to have a reasonable basis for extending audit conclusions from an interim date to year-end, the auditor should evaluate whether performing only substantive procedures to cover the remaining period is sufficient. If the auditor concludes that substantive procedures alone would not be sufficient to cover the remaining period, tests of the operating effectiveness of relevant controls should be performed or the substantive tests should be performed as of year-end.
- .03 By performing interim tests before year-end, the auditor may be able to
- more quickly identify and address significant 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/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.
- .04 Interim testing of a line item/account or an assertion with a high risk of material misstatement typically involves greater detection risk than performing all substantive testing of line items/accounts/assertions 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.

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<sup>1</sup>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.

- .05 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/procedures, including decisions regarding the nature, extent, and timing of substantive procedures.
- .06 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 line item/account balances 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 line item/account balances consist of similar types of items at both dates.
  - **(Balance sheet accounts) The amount of the line item/account balance at the interim testing date in relation to the expected year-end balance:** A significant increase in the line item/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/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.

- .07 The auditor should document in the LIRA, or equivalent, the line items/accounts (and assertions, where applicable) 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.
- .08 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**

- .01 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 (but not limited to) knowledge of the entity; its business (purpose); applicable laws, regulations, contracts, and grant agreements; and internal control.
- .02 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 discussion of consideration of risk in planning begins at FAM 260.02. Use of risk in determining sample size is discussed in FAM 470.
- .03 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 IS Controls**

- .01 As discussed in FAM 240.09, the auditor should obtain sufficient knowledge of the significant accounting applications to understand the design of the procedures by which transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements (see AU-C 315.19 and FAM 320). When significant accounting applications include control activities that are dependent on information system processing, the auditor should assess IS controls using an appropriate methodology. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity's use of information systems and planning, directing, or performing audit procedures related to assessing IS controls. In the planning phase, the auditor should identify and document the control activities included in the significant accounting applications that are dependent on information system processing. Such control activities are often application and user controls. The auditor should then identify the general controls implemented at the entitywide, system, and application levels that help ensure the effective operation of the application and user controls included in the significant accounting applications. As discussed in FAM 270.02, 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 likely to be effective, the auditor should test IS controls using an appropriate methodology. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls. See FAM 360. See also FAM 310.10 through .13 and FAM 640 for further details on service organizations.
- .02 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**

- .03 General controls (implemented at the entitywide, 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:
- a. **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.

- b. **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.
- c. **Configuration management** involves the identification and management of security features for all hardware, software, and firmware<sup>1</sup> 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.
- d. **Segregation of duties** includes having policies, procedures, and an organizational structure to manage who can control key aspects of computer-related operations and thereby prevent 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.
- e. **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

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<sup>1</sup>Firmware is a program or programs recorded in permanent or semipermanent computer memory.

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.

The FISCAM has detailed guidance on evaluating and testing general controls. See FAM 240 and FAM 270 for additional discussion of general controls.

- .04 General controls are established at the entitywide, system, and application levels.
- In evaluating general controls at the entitywide 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.
- .05 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

- .06 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 entitywide and system-level general controls. Deficiencies in entitywide 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.

.07 FISCAM uses control categories that complement the methodology used in the FAM. Most of the following categories relate to the financial statement 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 amount/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

- .08 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 can be an IS control or a manual control. A user control is considered an IS control if a dependency on information system processing exists. 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 no dependency on information system processing exists. 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.

- .09 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**

- .01 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’s audit guidance. During planning, the auditor should understand the design of budget controls and determine whether they have been implemented as part of assessing the risk of material misstatement as discussed in FAM 250 and 260.
- .02 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.
- .03 **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.
- .04 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.** 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.** 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.** 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.
- .05 Although Congress provides budget authority to some federal entities on an annual basis in the appropriations act process, 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.

- .06 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**

- .01 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 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.
- a. **Antideficiency Act (ADA)**, as provided primarily in chapters 13 and 15 of Title 31, U.S. Code. Provisions: 31 U.S.C. 1341(a) (1) (A) and (B) and 31 U.S.C. 1517(a). See FAM 803.
  - b. **Federal Credit Reform Act (FCRA)**, as provided in Sections 661 through 661f of Title 2, U.S. Code. Provisions: 2 U.S.C. 661c (b) and (e). See FAM 804.
  - c. **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), and (f); and 31 U.S.C. 3719. See FAM 805.
  - d. **Prompt Payment Act (PPA)**, as provided in 31 U.S.C. Chapter 39 (Sections 3901 through 3907, Title 31, U.S. Code). Provisions: 31 U.S.C. 3902(a), (b), and (f) and 31 U.S.C. 3904. See FAM 806.
  - e. **Pay and Allowance System for Civilian Employees**, as provided primarily in chapters 51 through 59 of Title 5, U.S.C. Provisions: 5 U.S.C. 5332, 5343, 5376, and 5383. See FAM 807.
  - f. **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.
  - g. **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.
  - h. **Federal Employees' Compensation Act (FECA)**, as provided in 5 U.S.C. Chapter 81. Provisions: 5 U.S.C. Chapter 81, subchapter I. See FAM 810.
  - i. **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**

- .01 As discussed in FAM 260, the auditor's response to assessed fraud risks should (1) have an overall effect on the conduct of the audit; (2) address fraud risks that relate to management override of controls; and (3) for any fraud risks that relate to specific financial statement account balances or classes of transactions and related assertions, involve the nature, extent, or timing of audit procedures. This section provides examples of auditor responses in this third category—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**

- .02 Examples of auditor responses to fraud risks involving the nature, extent, or timing of audit procedures include the following:
- a. 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.
  - b. Inquiring of management regarding management's understanding of and response to the fraud risks that may exist at the entity's service organizations.
  - c. Inquiring of those charged with governance to obtain their insights about those risks and whether and how controls mitigate those risks.
  - d. 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.
  - e. Using data-mining or other computer-assisted audit techniques, such as Interactive Data Extraction and Analysis (IDEA), to gather more extensive evidence about data contained in significant accounts. Such techniques can be used to select audit sample items from electronic files, locate items with specific characteristics (to perform substantive analytical procedures or make a nonrepresentative selection), or test an entire population.
  - f. 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.
  - g. Conducting surprise or unannounced procedures, such as inventory observations or cash counts on unexpected dates or at unexpected locations.
  - h. 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.
  - i. Where a specialist's (see FAM 620 and AU-C 620) work is particularly significant, 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.
  - j. Performing additional or more focused tests of budget to actual variances and their underlying causes.

- k. Performing targeted tests of the timing of cost/expense recognition.
- l. Requesting that physical inventory counts be made on or closer to year-end.
- m. 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).
- n. Testing a larger sample of disbursement transactions for validity.
- o. 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).
- p. 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 Misstatements Arising from Fraudulent Financial Reporting**

- .03 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) management's estimates, (2) revenue recognition, and (3) inventory quantities. These example responses involve the nature, extent, and timing of audit procedures.

#### **Management's Estimates**

- .04 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.
- .05 Examples of procedures that the auditor may perform in response to fraud risks related to management estimates include the following:
- a. Gathering additional information about the entity and its environment to assist in more extensively evaluating the reasonableness of management's estimates and underlying judgments and assumptions, focusing on more sensitive or subjective aspects.
  - b. 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.

- c. Using the work of a specialist to evaluate management's estimate, or developing an independent estimate to compare to management's estimate.

### **Revenue Recognition**

- .06 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.
- .07 Examples of procedures that the auditor may perform in response to fraud risks related to improper revenue recognition include the following:
  - a. 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 through .05) at a lower percentage of tolerable misstatement. Audit techniques such as regression analysis may be helpful in performing these procedures.
  - b. 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.
  - c. Confirming with customers and other appropriate parties the relevant contract terms and the absence of side agreements that may influence the appropriate accounting.
  - d. 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.
  - e. Expanding tests of general and application controls related to revenue transactions that are electronically initiated, processed, and recorded.

### **Inventory Quantities**

- .08 Examples of procedures that the auditor may perform in response to fraud risks related to inventory quantities include the following:
  - a. 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.
  - b. Performing additional inventory observation 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.

- c. 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.
- d. 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.
- e. Using computer-assisted audit techniques (such as IDEA) 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.
- f. Establishing the limit (see FAM 475.04 through .05) at a lower percentage of tolerable misstatement when performing substantive analytical procedures related to inventories.

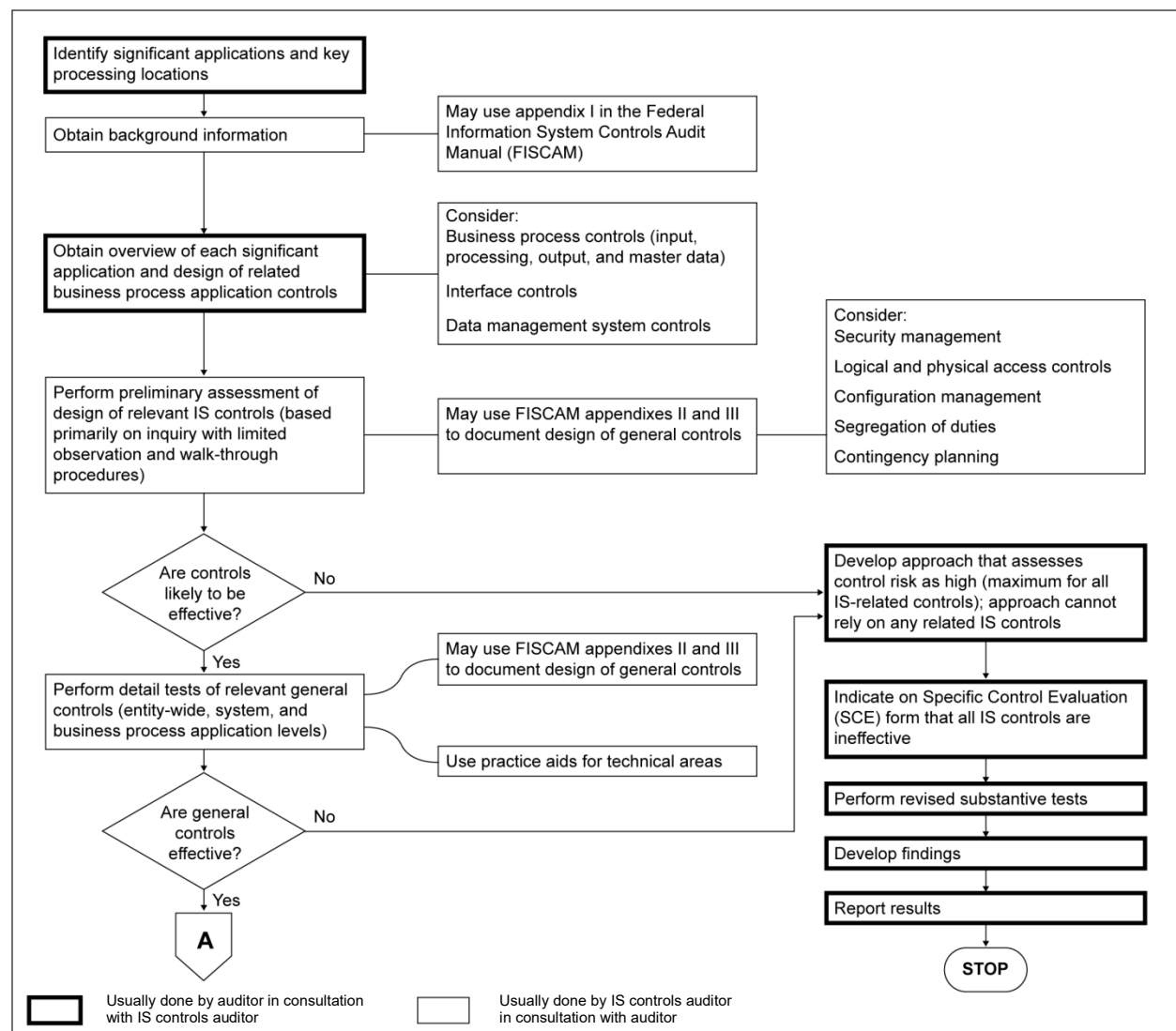
### **Additional Examples of Auditor Responses to Fraud Risks Related to Misstatements Arising from Misappropriation of Assets**

- .09 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:
- a. Using information on any improper payments, including information from entity review of programs and activities under the Improper Payments Information Act of 2002, as amended, to develop and perform audit procedures focused on specific vulnerable areas.
  - b. 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.
  - c. 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.
  - d. 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.
  - e. Establishing the limit (see FAM 475.04 through .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 IS Controls

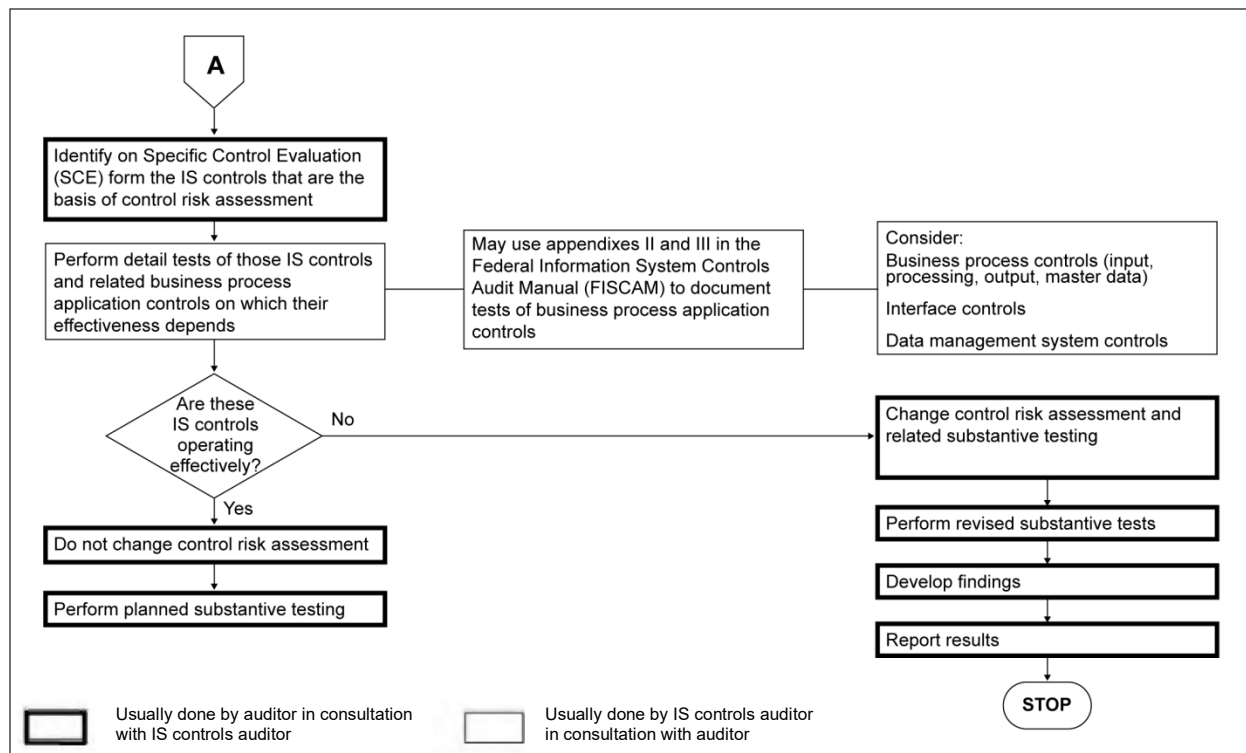
- .01 As discussed in FAM 270, the following flowcharts illustrate steps the auditor and the IS controls auditor generally follow in understanding and assessing IS controls in a financial statement audit. However, the audit team may decide to test the effectiveness of the general controls even if they 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**





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



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# SECTION 300

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## Internal Control Phase

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## **310 – Overview of the Internal Control Phase**

.01 In the internal control phase, the auditor continues the risk assessment procedures begun in the planning phase. The auditor expands the understanding of the entity's internal control gained during the planning phase of the audit in FAM 200 for all types of controls and, for financial reporting controls, assesses control risk and risk of material misstatement separately for each significant financial statement assertion in each significant cycle or accounting application. (See contents.) The auditor should

- understand and document the design of each of the five components of internal control and whether the controls are implemented to prevent, or detect and correct, misstatements;
- assess the control risk component of the risk of material misstatement and assess the risk of material misstatement on a preliminary basis;
- plan the nature, extent, and timing of control tests; and
- perform any nonsampling control tests (see FAM 360) of control effectiveness for internal controls that have been designed and implemented effectively to support a low assessed level of control risk.

The auditor uses results of this internal control work to

- reassess the risk of material misstatement;
- determine the nature, extent, and timing of further audit procedures (sampling control, compliance, and substantive testing discussed in FAM 400);
- update the evaluation of internal control as further evidence is obtained throughout the audit;
- determine any effects on the risk of material misstatement and the related sufficiency of other audit procedures (discussed in FAM 400 and 500); and
- use the audit evidence obtained during the internal control and testing phases to form an opinion or report on internal control over financial reporting (discussed in FAM 500).

.02 Office of Management and Budget (OMB) audit guidance requires the auditor to perform sufficient tests of internal controls that have been suitably designed and implemented to conclude whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). Thus, the auditor should not elect to forgo control tests solely because it is more efficient to extend substantive and compliance audit procedures.

.03 Management, with oversight by those charged with governance or other oversight bodies, sets objectives to meet the entity's mission, strategic plan, and goals and requirements of applicable laws and regulations. Management groups objectives into one or more of the three categories of objectives: operations, reporting, and compliance. Operations objectives relate to program operations that achieve an entity's mission. Reporting objectives relate to the preparation of reports for use by the entity, its stakeholders, or other external parties. Reporting objectives may be grouped further into the following subcategories: external

financial reporting objectives, external nonfinancial reporting objectives, and internal financial reporting objectives and nonfinancial reporting objectives. Compliance objectives relate to compliance with applicable laws, regulations, contracts, and grant agreements. Entity management is responsible for establishing and maintaining internal control over financial reporting to provide reasonable assurance that the entity's objectives will be met. In a financial statement audit, the auditor evaluates those internal controls designed to provide reasonable assurance that the following objectives are met.

- **Reliability of financial reporting:** Transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with U.S. generally accepted accounting principles (U.S. GAAP), and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.
- **Compliance with provisions of applicable 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.

.04 The auditor should determine whether such internal control provides reasonable assurance that misstatements, losses, or noncompliance, material in relation to the financial statements, would be prevented, or detected and corrected, during the period under audit. If the auditor intends to opine on internal control, the auditor should form a separate conclusion on internal control over financial reporting as of the end of the period. Additionally, the auditor may test certain operations controls, as discussed in the planning phase (FAM 275).

.05 Internal control over safeguarding assets constitutes a process, implemented by management and other personnel, designed to provide reasonable assurance regarding the prevention, or prompt detection and correction, of unauthorized acquisition, use, or disposition of entity assets that could have a material effect on the financial statements (AU-C 940.29). Safeguarding controls consist of (1) controls that prevent, or detect and correct, unauthorized access (direct or indirect) to assets and (2) segregation of duties.

The auditor should understand the design of certain safeguarding controls as part of financial reporting controls. These controls relate to protecting assets from loss arising from handling the related assets and resulting in misstatements in processing transactions. FAM 395 C includes a list of typical control activities. The auditor need not evaluate safeguarding controls related to the loss of assets arising from management's business decisions. Such a loss may occur from incurring expenditures for equipment or material that might prove to be unnecessary, which is part of operations controls.

.06 Just as safeguarding controls are a subset of operations, reporting, and compliance controls, budget controls are a subset of financial reporting and compliance controls. Budget controls that provide reasonable assurance that budgetary transactions, such as obligations and outlays, are properly recorded, processed, and summarized to permit the preparation of the financial statements, primarily the statement of budgetary resources in accordance with U.S. GAAP, are financial reporting controls. Budget controls are generally also compliance

controls in that they provide reasonable assurance that transactions are executed in accordance with laws governing the use of budget authority. Some budget controls may be compliance controls only, for example, controls over allotments to prevent Antideficiency Act violations.

- .07 If the auditor's understanding is that the control has been designed and implemented effectively, the auditor should test the following types of controls:
- **Financial reporting controls** (including certain **safeguarding** and **budget controls**) for each significant assertion in each significant cycle/accounting application (identified in FAM 240).
  - **Compliance controls** for each significant provision of applicable laws, regulations, contracts, and grant agreements identified for testing (see FAM 245), including **budget controls** for each relevant budget restriction (see FAM 250).
  - **Operations controls** (1) for data relied on in performing financial audit procedures or (2) selected for testing by the audit team.
- .08 The auditor is not required to test controls that have not been designed and implemented effectively. Thus, internal controls that are not effective in design (based on work performed during the design phase of the current year) do not need to be tested. If the auditor determined in a prior year that a control in a particular accounting application was ineffective and if management indicates that the control has not improved, the auditor need not test it in the current year. On the other hand, if controls have been determined to be designed and implemented effectively, the auditor should perform sufficient tests of their effectiveness to support a low assessed level of control risk.
- .09 If the auditor expects to disclaim an opinion because of scope limitations, the auditor may limit internal control work to updating the understanding of the design of controls and whether they have been implemented. The auditor may do this by inquiring as to whether previously identified control weaknesses have been corrected. In the year the auditor expects to issue an opinion on the financial statements, the auditor should perform sufficient work on internal control to support the opinion.
- .10 In gaining an understanding of an entity's internal control, including internal control related to information systems, including the related business processes relevant to financial reporting and communication related to services provided by a service organization, the auditor should obtain evidence about the design of relevant controls and whether they have been implemented. In obtaining evidence about whether controls have been implemented, the auditor should determine whether the entity is using them, rather than merely having them written in a manual, for example. This differs from determining a control's operating effectiveness, which is concerned with how the control was applied; the consistency with which it was applied; and by whom and by what means it was applied, including when applicable whether the person performing the control has the necessary authority and competence to perform it effectively (AU-C 330.10a).
- .11 The auditor should obtain an understanding of how the entity uses the services of a service organization in the entity's operations for assessing risk and planning other audit procedures, including the following:

- the nature of the services provided by the service organization and the significance of those services to the entity, including their effect on the entity's internal control;
- the nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organization;
- the degree of interaction between the activities of the service organization and those of the entity;
- the nature of the relationship between the entity and the service organization, including the relevant contractual terms for the activities undertaken by the service organization (AU-C 402.09); and
- if performing an audit of internal control over financial reporting, the auditor should consider the activities of the service organization when determining the evidence required to support the auditor's opinion on the effectiveness of the entity's internal control over financial reporting (AU-C 940.88).

The auditor<sup>1</sup> should evaluate the design and implementation of relevant controls at the entity that relate to the services provided by the service organization, including those that are applied to the transactions processed by the service organization (AU-C 402.10). The auditor should determine whether a sufficient understanding of the nature and significance of the services provided by the service organization and their effect on the entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement (AU-C 402.11). If the auditor is unable to obtain a sufficient understanding from the entity, the auditor should obtain that understanding from one or more of the following procedures:

- Obtaining and reading a type 1<sup>2</sup> or type 2<sup>3</sup> report, if available.
- Contacting the service organization, through the entity, to obtain specific information.
- Visiting the service organization and performing procedures that will provide the necessary information about the relevant controls at the service organization.
- Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organization. (AU-C 402.12)

In addition, the auditor should inquire of management of the entity about whether

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<sup>1</sup>In this section, the term "auditor" is referring to the "user auditor" and the term "entity" is referring to "user entity" as defined in AU-C 402.

<sup>2</sup>Report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date.

<sup>3</sup>Report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design and operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period.

the service organization has reported to the entity, or whether the entity is otherwise aware of, any fraud; noncompliance with provisions of laws, regulations, contracts, or grant agreements; or uncorrected misstatements affecting the financial statements of the entity. The auditor should evaluate how such matters, if any, affect the nature, timing, and extent of the auditor's further audit procedures, including the effect on the auditor's conclusions and auditor's report (AU-C 402.19).

See FAM 640 for further guidance on audit considerations regarding service organizations.

- .12 OMB audit guidance requires for those service organization controls that are relevant to the audit and have been suitably designed and implemented, service organizations should either (1) provide an audit report (service organization type 2 report) on whether management's description of the service organization's system fairly presents the service organization's system that was designed and implemented throughout the specified period, internal controls were suitably designed to achieve the specified objectives and implemented throughout the specified period, and the controls that were tested were operating effectively to provide reasonable assurance that the related control objectives were met during the period specified or (2) allow user auditors to perform appropriate tests of controls at the service organization. If the service organization report does not exist, or the auditor does not judge the scope of these reports to be sufficient, the auditor should request to perform the work directly or to have the service auditor perform such work.
- .13 The service organization auditor may perform substantive procedures for use by the entity auditor. If necessary substantive procedures are not performed by the service organization auditor, the entity auditor should request to perform this work directly. The entity auditor should determine whether sufficient audit evidence has been obtained to meet the audit objectives.
- .14 If the auditor is giving an opinion on internal control and is unable to obtain sufficient evidence concerning the effectiveness of internal control, the auditor should qualify the opinion or disclaim an opinion on the entity's internal control, if applicable, due to a scope limitation, as discussed in FAM 580.34 through .36 and .52 through .54. If the auditor is not providing an opinion on internal control, the auditor should evaluate whether the audit evidence is sufficient for purposes of achieving the audit objectives related to internal control described in the OMB audit bulletin. The auditor also should evaluate whether the scope of the work is sufficient for purposes of meeting the audit objective related to compliance with applicable laws, regulations, contracts, and grant agreements. If the scope is not sufficient, the auditor should report a scope limitation as discussed in FAM 580.84 through .86.
- .15 In the internal control phase, the auditor should perform and document the following procedures:
- Understand the entity's design of the information systems for financial reporting; compliance with applicable provisions of laws, regulations, contracts, and grant agreements; and relevant operations (see FAM 320).
  - Identify control objectives by assertion (see FAM 330).



- Identify and understand relevant control activities that effectively achieve the control objectives by assertion (see FAM 340).
- Determine whether controls have been implemented and the nature, extent, and timing of control testing (see FAM 350).
- Perform control tests of control effectiveness that do not involve sampling (nonsampling control tests) (see FAM 360).<sup>4</sup> Sampling control tests, if necessary, are performed in the testing phase (see FAM 450).
- On a preliminary basis, based on the evidence obtained, assess (1) the effectiveness of financial reporting, compliance, and relevant operations controls; (2) control risk; and (3) the risk of material misstatement (see FAM 370). The risk of material misstatement includes inherent and control risk and is discussed in FAM 370.09.
- Consider partial-year controls and planned changes in controls (see FAM 380).
- Document the understanding and testing of controls (see FAM 390).

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<sup>4</sup>The auditor generally should coordinate sampling control tests with substantive audit procedures and/or tests of compliance with applicable laws, regulations, contracts, and grant agreements (multipurpose tests) to maximize efficiency. See FAM 450 for further discussion.

## **320 – Understand Information Systems**

- .01 The auditor should obtain an understanding of the design of the entity's information systems (whether automated or manual), including the processes relevant to financial reporting, for processing and reporting of
- accounting, budget, compliance, and operations data and
  - maintaining accountability for the related assets, liabilities, equity, and budgetary resources.<sup>1</sup>

These systems include procedures established to initiate, authorize, record, process, and report entity transactions (as well as events and conditions) to maintain accountability and to monitor compliance. Information systems are part of the information and communication component of internal control. The communication portion of this component is in FAM 260.

The auditor should obtain sufficient knowledge of each type of system to understand the information reflected in FAM 320.03 through .07 in a manner that is appropriate to the entity's circumstances. This includes obtaining an understanding of how transactions originate within the entity's business processes, as discussed in AU-C 315.A87. It also includes understanding procedures for preparing financial statements and related disclosures (including year-end journal entries and reclassifications) and understanding how misstatements may occur. The auditor should identify the points within the entity's processes at which a misstatement, including a misstatement due to fraud, could arise that individually or in combination with other misstatements, would be material (for example, points at which information is initiated, transferred, or otherwise modified) (AU-C 940.29).

If the auditor has determined that any of the significant financial management systems are maintained by a service organization, then the auditor should follow the guidance outlined in FAM 640.05 through .10.

Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity's use of information systems and 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. The auditor may also coordinate with or leverage work performed by the FISMA auditor/evaluator in understanding entity's IS control environment. The auditor should document the understanding of these systems in cycle memorandums, or other equivalent narratives, and may prepare or obtain related flowcharts. FAM 340 and 350 discuss identifying and documenting controls that are designed to mitigate inherent risk.

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<sup>1</sup>As indicated in FAM 260.65 through .70, the Federal Managers' Financial Integrity Act report and its supporting documentation may be used as a starting point for understanding and evaluating internal control. The auditor may use management's documentation of systems and internal control, including A-123 work, where appropriate. The auditor may use management's tests of controls as part of the auditor's tests of controls, if such tests were executed by competent individuals independent of the controls. (See FAM 640 and FAM 645 for further information.)

- .02 The auditor generally should perform sufficient system walk-throughs to confirm the understanding of significant information about such systems and discuss any system changes with management. FAM 350.10 discusses walk-throughs to confirm the auditor's understanding of controls. In a walk-through of an accounting system, the auditor traces one or more transactions from initiation through all processing to inclusion in the general ledger, observing the processing in operation, making inquiries of entity staff, and examining related documents.

Walk-throughs are important for understanding the transaction process and for determining appropriate audit procedures. The auditor should perform walk-throughs for all significant accounting applications. Walk-throughs of budget, accounting, compliance, and operations systems provide evidence about the functioning of such systems. The auditor should document these walk-throughs. The auditor should incorporate the information technology aspects of each system into the audit documentation and may include additional flowcharts, narratives, and checklists.

### **Accounting System(s)**

- .03 For each significant cycle and accounting application identified for significant line items and assertions in FAM 240, the auditor should obtain an understanding of and should document the design of
- procedures by which transactions are initiated, authorized, recorded, processed, summarized, and reported in the financial statements;
  - nature and type of related records, journals, ledgers, feeder systems, and source documents, and the accounts involved;
  - processing involved from the initiation of transactions to their inclusion in the financial statements, including the nature of computer files and the manner in which they are accessed, updated, and deleted;
  - process for resolving the incorrect processing of transactions, for example, such an understanding might include how the entity determines whether suspense items are cleared out of an automated suspense file on a timely basis and how system overrides or bypasses to controls are processed and accounted for;
  - processes for reconciling transaction detail to the general ledger and correcting reconciling items as needed;
  - processes by which the information systems capture events and conditions, other than classes of transactions, that are significant to the financial statements;
  - processes used to prepare the entity's financial statements and budget execution information, including significant accounting estimates, disclosures, and information system processing. Because of its importance to financial reporting and to the integrated audit, the auditor should evaluate the period-end financial reporting process (AU-C 940.24). These processes include
    - procedures used to enter transaction totals into the general ledger;

- procedures related to the selection and application of accounting policies;
- procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- procedures used to record recurring and nonrecurring adjustments to the financial statements;
- procedures for preparing financial statements (AU-C 940.24); and
- procedures used to combine and consolidate general ledger data; and
- period-end financial reporting process, including manual and automated procedures, for preparing the financial statements and related disclosures. Because of its importance to financial reporting, the auditor should evaluate the period-end financial reporting process.

As part of evaluating the period-end financial reporting process, the auditor should assess

- the inputs, procedures performed, and outputs of the processes the entity uses to produce its financial statements;
- the extent of information system processing in the period-end financial reporting process;
- who participates from management;
- the locations involved in the period-end financial reporting process;
- the types of adjusting and consolidating entries; and
- the nature and extent of the oversight of the process by management and those charged with governance (AU-C 940.25).

- .04 When the auditor is required to report on compliance with the Federal Financial Management Improvement Act of 1996 (FFMIA), the auditor's understanding of these processes can help the auditor determine whether the financial management systems comply substantially with federal financial management systems requirements, federal accounting standards, and the *U.S. Standard General Ledger* (SGL) at the transaction level. If the entity is likely to receive an unmodified opinion and to have no identified material weaknesses in internal control, the auditor should test significant information that the entity provides to support its assertion about the substantial compliance of its financial management systems. The auditor may perform this testing in conjunction with nonsampling control tests (see FAM 350).

## **Budget Accounting System(s)**

- .05 Through discussions with appropriate entity personnel, the auditor should understand and document the design of the entity's processes for
- developing and requesting apportionments from OMB;
  - establishing and allocating allotments within the entity, including reprogramming of allotments;
  - establishing and recording commitments, if applicable;

- establishing, recording, and monitoring obligations (undelivered orders, which include contracts and purchase orders);
- establishing and recording expended authority (delivered orders);
- establishing and recording outlays;
- monitoring supplemental appropriations;
- deobligating excess amounts when orders are completed;
- recording transactions in and adjustments to expired accounts; and
- monitoring canceled (closed) accounts.

### **Compliance System(s)**

- .06 The compliance system includes the entity's policies and procedures to monitor compliance with provisions of laws, regulations, contracts, and grant agreements applicable to the entity. Through discussions with appropriate entity personnel, the auditor should understand and document the design of the entity's process for
- identifying and documenting all laws, regulations, contracts, and grant agreements applicable to the entity;
  - monitoring changes in applicable laws, regulations, contracts, and grant agreements and responding on a timely basis;
  - establishing policies and procedures for complying with specific laws, regulations, contracts, and grant agreements and clearly documenting and communicating these policies and procedures to appropriate personnel;
  - ensuring that an appropriate number of competent individuals at appropriate levels within the entity monitor the entity's compliance with applicable laws, regulations, contracts, and grant agreements; and
  - investigating, resolving, communicating, and reporting any noncompliance with provisions of applicable laws, regulations, contracts, and grant agreements.

### **Operations System(s)**

- .07 Through discussions with appropriate entity personnel, the auditor should understand and document the design of entity systems in which the operations controls to be evaluated and tested operate. The auditor should test operations controls relied on in performing financial audit procedures, such as using entity-prepared data for substantive tests. For example, if the auditor intends to evaluate and test an operations control that depends on certain statistical information that will be used in a substantive analytical procedure, the auditor should understand how the statistical information is developed. See FAM 275.08 for examples of the auditor using entity-prepared reports for substantive tests and discussions of tests of related controls over the report data, such as operational controls.

## **330 – Identify Control Objectives**

- .01 In designing their systems, entities identify control objectives for each type of control that if achieved, would provide the entity with reasonable assurance that individual and aggregate misstatements (whether caused by error or fraud), losses, or noncompliance material to the financial statements would be prevented, or detected and corrected. For social insurance and nonmonetary information in the financial statements, such as physical units of heritage assets, the objectives would relate to controls that would provide reasonable assurance that misstatements, losses, or noncompliance that would be considered material by users of the information would be prevented, or detected and corrected. These control objectives can be classified as follows:
- **Financial reporting controls** to prevent, or detect and correct, misstatements in significant financial statement assertions. These include **safeguarding controls** to safeguard assets against loss from unauthorized acquisition, use, or disposition and **segregation-of-duties controls** to prevent one person from controlling multiple aspects of a transaction, allowing that person to both cause and conceal misstatements whether due to error or fraud.
  - **Budget controls** to provide reasonable assurance that the entity (1) properly records, processes, and summarizes transactions to permit the preparation of the statement of budgetary resources and reconciliation of net cost to budget note disclosure in accordance with U.S. GAAP and (2) executes transactions in accordance with budget authority.
  - **Compliance controls** to comply with significant provisions of applicable laws, regulations, contracts, and grant agreements.
  - **Operations controls** to achieve the performance desired by management for planning, productivity, quality, economy, efficiency, or effectiveness of the entity's operations.

FAM 330.02 through .11 describes the process for identifying control objectives.

### **Financial Reporting Controls**

- .02 The auditor should evaluate and test **financial reporting controls** for each significant assertion in each significant financial statement line item or account, including related disclosures if the auditor has determined that controls have been designed and implemented effectively. (See FAM 235.02 for a discussion of financial statement assertions.) The first step in identifying control objectives for financial reporting controls is to consider the types of misstatements that might occur in each significant assertion in each significant line item or account. One or more potential misstatements can occur in each financial statement assertion. For example, for the existence or occurrence assertion, potential misstatements can occur in four areas.
- **Occurrence/validity:** Recorded transactions and events do not represent economic events that actually occurred that pertain to the entity.
  - **Cutoff:** Transactions are recorded in the current period, but the related

economic events occurred in a different period.

- **Summarization:** Transactions are summarized improperly, resulting in an overstated total.
- **Substantiation:** Recorded assets and liabilities of the entity do not exist at a given date.

For each potential misstatement in each assertion, there are one or more control objectives that if achieved, would prevent, or detect and correct, the potential misstatement. These potential misstatements and control objectives provide the auditor with the primary basis for assessing the effectiveness of an entity's control activities.

## Identifying Potential Misstatements and Control Objectives

- .03 As discussed in FAM 240, the auditor identifies the significant accounting applications that provide the source of significant entries to each significant line item or account. Each significant line item or account is affected by input from one or more accounting applications. Accounting applications are classified as (1) transaction related or (2) line item/account related. For example, as illustrated in FAM 395 A, sources of significant entries to cash typically include the cash receipts (transaction related), cash disbursements (transaction related), payroll (transaction related), and cash (line item/account related) accounting applications, while sources of significant entries to accounts receivable typically include the billing (transaction related), cash receipts (transaction related), and accounts receivable (line item/account related) accounting applications. The auditor should identify the accounting applications in the cycle matrix and Line Item Risk Analysis (LIRA) form, or equivalent documentation.
- .04 The auditor should understand how potential misstatements in significant accounting applications could affect the related line item or account at an assertion level. For example, an overstatement of cash receipts typically results in (1) an overstatement of the cash account (by overstating the debit to cash) and (2) an understatement of accounts receivable (by overstating the credit to accounts receivable).
- To illustrate this concept using the assertions, a misstatement in the existence or occurrence assertion for cash receipts typically results in misstatements in (1) the existence or occurrence assertion for the cash account and (2) the completeness assertion for accounts receivable.
- .05 To understand the effect of potential misstatements as discussed in FAM 330.04, the auditor may consult table 330 regarding transaction-related accounting application assertions as they affect line items/account assertions.

**Table 330: Transaction-Related Accounting Application Assertions and Line Items/Account Assertions Affected**

| Transaction-related accounting application assertion | Line item/account assertions affected   |
|--|---|
| <b>Existence or occurrence</b>                       | <ul style="list-style-type: none"> <li>Existence or occurrence, if the application increases the line item/account balance</li> <li>Completeness, if the application decreases the line item/account balance</li> </ul> |
| <b>Completeness</b>                                  | <ul style="list-style-type: none"> <li>Completeness, if the application increases the line item/account balance</li> <li>Existence or occurrence, if the application decreases the line item/account balance</li> </ul> |
| <b>Accuracy/valuation</b>                            | <ul style="list-style-type: none"> <li>Accuracy/valuation</li> </ul>  |

- .06 For each potential misstatement in the accounting application, the auditor should identify related control objectives (and ultimately related controls) that could prevent, or detect and correct, the potential misstatement. FAM 395 B includes a list of potential misstatements that could occur in each assertion in an accounting application and related control objectives. The auditor exercises judgment in determining which potential misstatements and control objectives to use. The auditor should tailor the list included in FAM 395 B to the accounting application and to the entity and should supplement the list with additional objectives or subobjectives, as appropriate.
- .07 If the auditor performs procedures that are documented by line item or account, a given accounting application might be addressed two or more times. For example (see FAM 395 A), the purchasing accounting application typically would be addressed in evaluating controls relating to the inventory, property, liabilities, expense, and obligation accounts. To avoid duplication, the auditor may use a Specific Control Evaluation (SCE) worksheet or equivalent to document the procedures discussed in FAM 330.03 through .06. The SCE worksheet groups potential misstatements and control objectives by accounting application (within each cycle), providing a format for performing and documenting the evaluation and testing of internal controls efficiently. See FAM 395 G for an example of an SCE worksheet. Sample forms for preparing the LIRA form and SCE worksheet electronically are available at [www.gao.gov](http://www.gao.gov).



## The Need for Testing Safeguarding and Segregation-of-Duties Controls

- .08 **Safeguarding controls** and **segregation-of-duties controls** are often critical to the effectiveness of controls over liquid (easily sold or traded) and readily marketable assets (such as cash, inventories, or property) that are highly susceptible to theft, loss, or misappropriation in material amounts. These controls are also important when there is an increased risk of fraud. **Before selecting specific control activities to test**, the auditor should determine whether safeguarding controls are relevant and consider materiality of the assets.

If the auditor determines that (1) an asset is highly liquid or marketable and (2) material amounts are susceptible to theft, loss, or misappropriation, the auditor should include control objectives for safeguarding such assets and understand whether safeguarding controls have been designed and implemented effectively and, if so, should test safeguarding controls. On the other hand, if the asset is not liquid or marketable or amounts readily susceptible to theft, loss, or misappropriation are not material, the auditor might not need to understand and test safeguarding controls. Testing for segregation of duties is discussed in FAM 360.13 through .14. The auditor may evaluate other safeguarding controls in connection with financial reporting controls.

## Budget Controls

- .09 The objectives of **budget controls** are to provide reasonable assurance that the entity (1) properly records, processes, and summarizes transactions to permit the preparation of the statement of budgetary resources and reconciliation of net cost to budget note disclosure in accordance with U.S. GAAP and (2) executes transactions in accordance with budget authority. FAM 395 F presents a list of budget control objectives, organized by steps in the budget process. In addition, FAM 395 D presents a list of selected statutes relevant to the budget, and FAM 395 E describes budget steps of interest to the auditor in evaluating an entity's budget controls. The auditor may document budget control objectives in a separate SCE worksheet for budget controls, in a memo, or incorporate them in an SCE worksheet with related financial reporting controls.

## Compliance Controls

- .10 The objective of **compliance controls** is to provide reasonable assurance that the entity complies with significant provisions of applicable laws, regulations, contracts, and grant agreements. The auditor should identify compliance control objectives for the related provision identified for testing and may document these objectives in a separate SCE worksheet for compliance controls, in a memo, or incorporate them in an SCE worksheet with related financial reporting controls.

## Operations Controls

- .11 The objectives of **operations controls** are to provide reasonable assurance that the entity effectively and efficiently meets its mission. The auditor should identify control objectives for any operations controls identified for testing and may document operations control objectives in a separate SCE worksheet for

operations controls, in a memo, or incorporate them into an SCE worksheet with related financial reporting controls.

The auditor should test operations controls relied on in performing financial audit procedures, and any others selected for testing by the audit team, if any. See FAM 275.08 and FAM 495 A.21 through .22 for examples of the auditor using entity-prepared reports for substantive tests, such as substantive analytical procedures, and discussions of tests of related controls over the report data, such as operations controls.

## **340 – Identify and Understand Relevant Control Activities**

- .01 For each control objective, based on discussions with entity personnel and the results of other procedures performed, the auditor should identify the control activities for achieving the specific control objective.<sup>1</sup> These control activities may be designed by management and may also include control activities designed and implemented by a service organization used by the entity. The auditor should determine whether the control activities identified are dependent on information system processing. 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. The auditor may indicate these controls in the auditor’s informal notes and/or interview write-ups for use in the following procedures, but the auditor need not formally document them in the SCE worksheet at this time. The auditor should then identify those that are effective in design to test. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity’s use of information systems and in planning, directing, or performing audit procedures related to assessing IS controls. For example, an IS controls auditor may assist the auditor in identifying and understanding the design of application controls and general controls implemented at the entitywide, system, and application levels that help ensure the effective operation of the control activities that are dependent on information system processing. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls. As discussed in FAM 350, the auditor should use walk-throughs, inquiry, and observation to determine whether the entity has implemented these controls identified for further audit procedures. The auditor should use FAM 640 if an entity uses a service organization.

### **Basic Understanding of Effectiveness of Control Activities**

- .02 The auditor should obtain a sufficient understanding of the design of the identified control activities to determine whether they are likely to achieve the control objectives, assuming an effective control environment, entity risk assessment, information and communication, monitoring, appropriate segregation of duties, and effective general controls. The purpose of this assumption is for the auditor to identify any deficiencies in the specific control activities of the entity that the auditor should report as discussed in FAM 580 and recommend that the entity correct. Often only multiple control activities, together with other components of internal control (control environment, risk assessment, information and communication, and monitoring) will be sufficient to address a risk.

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<sup>1</sup>FAM 395 C presents a list of typical control activities that an entity may establish to help prevent or detect and correct misstatements in financial statement assertions.

## Factors to Consider

- .03 When evaluating whether controls are likely to achieve the control objectives, the factors that the auditor should consider include

- directness,
- selectivity,
- manner of application, **and**
- follow-up.

In determining whether control objectives are achieved, the auditor should consider both manual and IS controls, if likely to be effective (see FAM 270).

- .04 **Directness** refers to the extent to which a control activity relates to a control objective. The more direct the relationship, the more effective that activity may be in achieving the objective. For example, management reviews of inventory reports that summarize the inventory by storage facility may be less effective in preventing, or detecting and correcting, misstatements in the existence assertion for inventory than a periodic physical inventory, which is more directly related to the existence assertion.

- .05 **Selectivity** refers to the magnitude of the amount, or the significance of other criteria or distinguishing characteristics, that a specific control will identify as an exception condition. Examples of selectivity thresholds are (1) a requirement for additional approvals of all payments to vendors in excess of \$25,000 and (2) management reviews of all payments to vendors not on an entity's approved vendor list. When determining whether a control is likely to be effective, the auditor should evaluate the likelihood that items that do not meet the selectivity threshold could, in the aggregate, result in material misstatements of financial statements; material noncompliance with budget authority; material noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements; or significant ineffective or inefficient use of resources.

The auditor also should evaluate the appropriateness of the specified criteria used to identify items in a management or exception report. For example, IS input controls (such as the matching of vendor invoices with receiving reports and purchase orders) that require exact matches of data from different sources before a transaction is accepted for processing may be more effective than controls that accept transactions that fall within a broader range of values. On the other hand, controls based on exception reports that are limited to selected information or use more selective criteria may be more effective than lengthy reports that contain excessive information.

- .06 **Manner of application** refers to the way in which an entity places a specific control into operation. The manner of application can influence the effectiveness of a specific control. When determining the effectiveness of controls, the auditor should evaluate the following:

- **Frequency of application:** This refers to the regularity with which controls are applied. Generally, the more frequently a control is applied, the greater the likelihood that it will be effective.

- **Authority and competence of personnel (AU-C 330.10a):** This refers to whether the person applying a control has the necessary authority and competence to properly apply it. If the person has less experience and skills or does not have the appropriate authority, it is less likely that the control will be effective. Also, the effective application of a control is generally adversely affected if the technique (1) is performed by an employee who has an excessive volume of work or (2) is not performed carefully.
- .07 **Follow-up** refers to the procedures performed when a control identifies an exception condition. A control's effectiveness depends on the effectiveness of follow-up procedures. To be effective, an entity needs to (1) apply these procedures on a timely basis, (2) determine whether control exceptions represent misstatements, and (3) correct all misstatements noted. For example, as a control, an accounting system may identify and put exception transactions into a suspense file or account. Lack of timely follow-up procedures by the entity to (1) reconcile and review the suspense file or account and (2) correct items in the suspense file or account would render the control ineffective.
- .08 When evaluating whether controls are likely to be effective, the auditor should evaluate whether the controls also are applied effectively to adjustments/corrections made to the financial records. Such adjustments/corrections may occur at the transaction level, or during summarization of the transactions, or may be posted directly to the general ledger accounts. Further, the auditor should also evaluate the design and implementation of controls applied to the financial statement preparation process.
- .09 Based on the understanding of the design of control activities and the determination of whether they are likely to achieve the control objectives, the auditor should assess control risk to decide whether to test controls. If control risk is high for a relevant assertion because the control activities for the related accounting application are not effective in design or likely to be effective in implementation (based on prior years' testing of the control activities, and the results of procedures performed in the current year to understand the controls, including management's indication that the controls have not improved from the prior year), the auditor does not need to test the operating effectiveness of the controls in the current year. According to OMB audit guidance, for those controls that have been suitably designed and implemented, the auditor will perform sufficient tests of such controls to conclude whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). Thus, the auditor should not elect to forgo control tests because it is more efficient to extend substantive and compliance audit procedures. Further, as discussed in FAM 350.07 through .09, the auditor generally should test only the control activities that are necessary to achieve the objective.

## **350 – Determine the Nature, Extent, and Timing of Control Tests and Compliance with FFMIA**

- .01 For each control objective, the auditor should
- identify specific relevant control activities to potentially test (FAM 350.07 through .09),
  - perform walk-throughs to determine whether those controls have been implemented (FAM 350.10),
  - document these control activities in the SCE worksheet or equivalent (FAM 350.11),
  - determine the nature of control tests (FAM 350.12 through .19),
  - determine the extent of control tests (FAM 350.20 through .21), and
  - determine the timing of control tests (FAM 350.22 through .23).

Internal control includes IS controls, as discussed further in FAM 360.03 through .10.

- .02 As noted in FAM 310.02, OMB audit guidance requires the auditor to perform sufficient tests of internal controls that have been suitably designed and implemented to conclude whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). Thus, the auditor should not elect to forgo control tests solely because it is more efficient to extend substantive and compliance audit procedures.

- .03 For Chief Financial Officers (CFO) Act agencies, the auditor also should determine the nature, extent, and timing of tests for determining whether the entity's financial management systems are in substantial compliance with federal financial management systems requirements (these requirements are established by the Department of the Treasury (Treasury) and published in the *Treasury Financial Manual* (TFM), volume 1, chapter 9500); federal accounting standards (U.S. GAAP—see FAM 560); and the SGL at the transaction level in order to report in accordance with FFMIA.

Substantial compliance includes the ability of the financial management systems to routinely provide reliable and timely financial information for managing day-to-day operations as well as to produce reliable financial statements, maintain effective internal control, and comply with legal and regulatory requirements.

Implementing FFMIA's requirements helps to ensure that agencies use financial management systems that provide reliable, timely, and consistent information. Agencies that can (1) prepare financial statements and other required financial budget reports using information generated by their financial management system(s); (2) provide reliable and timely financial information for managing current operations; (3) account for their assets reliably, so that they can be properly protected from loss, misappropriation, or destruction; and (4) do all three in a way that is consistent with U.S. GAAP and the SGL are substantially compliant with the three financial management systems requirements of FFMIA. See FAM 701 for further guidance and discussion.

- .04 If it is likely that the financial statement opinion will be unmodified and internal control will be determined to be effective, the auditor should plan to test the financial management systems' substantial compliance with the FFMIA requirements. On recurring audits for which FFMIA noncompliance was previously reported, the auditor should determine through inquiries and other procedures whether the entity has improved its controls and financial statement reporting to the point that the auditor should plan to test the system's substantial compliance with the three FFMIA requirements. Many control tests may also serve as tests for compliance with the systems requirements and the SGL and generally should be performed concurrently, as discussed in FAM 350.25.

Determining compliance with federal accounting standards (U.S. GAAP) involves substantive testing. Accordingly, the auditor may find it effective and efficient to combine tests for systems compliance with control and substantive testing (multipurpose testing). In addition, for purposes of FFMIA, financial management systems include systems that produce the information management uses day to day, not just systems that produce annual financial statements. Thus, to report on the financial management system's substantial compliance with the three FFMIA requirements, the auditor should understand the design of and test, as needed, the financial management systems (including the financial portion of any mixed systems) used for managing financial operations, supporting financial planning, management reporting, budgeting activities, and systems accumulating and reporting cost information.

- .05 For agencies with long-standing, well-documented financial management systems weaknesses that severely affect the systems' ability to comply substantially with FFMIA requirements, the auditor may not need to perform specific tests of the systems' compliance with the FFMIA requirements. By gaining an understanding of the design of the systems and performing internal control and substantive testing, the auditor may have adequate information about the systems to describe the instances of lack of substantial compliance and make recommendations, as required by FFMIA.

The auditor also should understand management's process for determining whether the entity's systems comply substantially with the FFMIA requirements and report any deficiencies in management's process (for example, management has not compared its systems with system requirements). Entity assessments for the Federal Managers' Financial Integrity Act (FMFIA) (A-123 work) may assist the auditor in understanding systems compliance with the FFMIA requirements.

- .06 If it is likely that the opinion on the financial statements will not be unmodified, that the entity has material weaknesses or significant deficiencies in internal control, or that it has significant noncompliance with legal and regulatory requirements, then the auditor may limit the scope of testing performed to support the FFMIA assessment. However, if the auditor is concerned that it may be difficult to convince management of the systems' noncompliance without specific tests, the auditor generally should perform the testing needed for this purpose. The extent of such testing is a matter of professional judgment. If the entity has improved its controls, and in contrast to prior years, the financial statement opinion may be unmodified, the auditor generally should test the systems for substantial compliance with the FFMIA requirements.

## Identify Relevant Control Activities to Potentially Test

- .07 For each control objective identified in FAM 330, the auditor should identify the control activity, or combination of control activities, that is likely to (1) achieve the control objective and (2) improve the efficiency of control tests. In doing this, the auditor should consider (1) the extent of any inherent risk<sup>1</sup> and control environment, entity risk assessment, communication, or monitoring weaknesses,<sup>2</sup> including those related to information systems (as documented in the LIRA form and/or audit strategy document, or equivalent (see FAM 260)), and (2) the tentative determination of the likelihood that IS controls will be effective (see also FAM 270).

The auditor generally should test only the control activities necessary to achieve the objective. For example, the entity may have several controls that are equally effective in achieving an objective. In such a case, the auditor generally should test the control activity that is efficient to test, considering such factors as (1) the extent to which a control achieves several control objectives and thereby reduces the number of controls that would ordinarily need to be tested; (2) the time that will be required to test the control; and (3) control dependencies, particularly for IS controls. A control dependency exists when the effectiveness of an internal control is dependent on the effectiveness of other internal controls. For example, when a dependency on information system processing exists, 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. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity's use of information systems and in planning, directing, or performing audit procedures related to assessing IS controls. For example, an IS controls auditor may assist the auditor in identifying and understanding the design of application controls and general controls implemented at the entitywide, system, and application levels that help ensure the effective operation of the control activities that are dependent on information system processing. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls. See also FAM 360. The auditor may also, based on risk, test different control activities from year to year in a recurring audit, but it does not change the auditor's responsibility to identify the control activity, or combination of control activities, in the current-year audit that are necessary to achieve the control objective.

- .08 For those control objectives for which the auditor preliminarily determines that effective control activities have been designed and implemented effectively to achieve the control objective, the auditor should test the selected control activities, as discussed in FAM 360 and FAM 450. The auditor may test all or only certain control activities (because others are not likely to be effective),

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<sup>1</sup>Assertions that have high inherent risk normally require stronger or more extensive controls to prevent, or detect and correct, misstatements than assertions without such risk.

<sup>2</sup>Control environment, risk assessment, communication, and monitoring weaknesses may result in ineffective control activities. If so, the auditor should still understand the design of specific control activities and determine whether they have been implemented, as discussed in FAM 340.02.



related to a control objective. Per OMB audit requirements for federal financial statements, the auditor should **not** elect to forgo control tests solely because it is more efficient to extend substantive or compliance audit procedures.

If, in any phase of the audit, the auditor determines that a control activity selected for testing is, in fact, ineffective in design or operation in achieving the control objective, the auditor may discontinue testing of that control activity and should report the identified deficiencies in internal control, as discussed in FAM 580.

- .09 Before testing controls the auditor believes will be effective, the auditor may complete the LIRA form or equivalent tentatively, assuming that such controls are effective.

## **Perform Walk-throughs to Determine Whether Controls Have Been Implemented**

- .10 Before performing control tests, the auditor should perform one or more walk-throughs of each control activity to determine whether the control activities are functioning in the manner understood by the auditor. These walk-throughs are designed to confirm the auditor's understanding of the design and implementation of the control activities as part of the auditor's risk assessment process and differ from those performed to confirm the auditor's understanding of the information systems (see FAM 320.02). Through observations, inspection, and discussions with personnel responsible for applying or maintaining each control (including walk-throughs), the auditor should determine whether each control has, in fact, been implemented. If a control has not been implemented, the auditor should consider whether other controls are likely to achieve the related control objective(s) (compensating controls) and should consider testing such other controls.

## **Document Control Activities to Be Tested**

- .11 The auditor should document the control activities to be tested in the SCE worksheet or equivalent (see an illustration in FAM 395 G). The auditor generally should test other components of internal control (control environment, risk assessment, information and communication, and monitoring) by a combination of observation, inquiry, or inspection (see FAM 260.09 and FAM 350.27 through .33). The auditor may list (and evaluate) controls that satisfy more than one control objective only once and refer to these controls, when applicable, on subsequent occasions. For each control to be tested, the auditor should determine whether the control is an IS control, as discussed in FAM 240 and FAM 295 F. The auditor generally should obtain concurrence from an IS controls auditor on the auditor's identification of IS controls that will be tested.

## **Determine the Nature of Control Tests**

- .12 To obtain additional sufficient, appropriate evidence of the effectiveness of specific controls, the auditor should determine the combination of control tests (**observation, inquiry, inspection, or reperformance**) to be performed. No one specific control test is always necessary, applicable, or equally effective in every circumstance. In designing and performing tests of controls, the auditor should perform other audit procedures in combination with inquiry to obtain sufficient, appropriate audit evidence regarding the operating effectiveness of controls,

including how the controls were applied at relevant times during the period under audit; the consistency with which they were applied; and by whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively (AU-C 330.10). The auditor should determine whether the controls to be tested depend upon other controls and, if so, whether it is necessary to obtain audit evidence supporting the operating effectiveness of those controls (AU-C 330.10.b). For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is of direct relevance to the auditor. In addition to obtaining audit evidence to support the completeness and accuracy of the exception reports, in this example, it may be necessary to obtain audit evidence supporting the general information technology controls (AU-C 330.A33). See FAM 340.03 for the factors to consider when evaluating whether controls are likely to achieve the control objective. In determining the types of tests to apply, the auditor should determine the tests that are effective and efficient, as discussed in FAM 350.16 through .19. Specific types of control tests and methods to apply them are discussed in the following paragraphs.

- .13 **Observation.** The auditor conducts observation tests by observing entity personnel actually performing control activities in the normal course of their duties. Observation generally provides highly reliable evidence that a control activity is properly applied when the auditor is there to observe it. However, it provides no evidence that the control was in operation at any other time. Consequently, the auditor should supplement observation tests with corroborative evidence obtained from other tests (such as **inquiry** and **inspection**) about the operation of controls at other times.
- .14 **Inquiry.** The auditor conducts inquiry tests by making either oral or written inquiries of entity personnel involved in the application of specific control activities to determine what they do or how they perform a specific control activity. Such inquiries are typically open ended. Evidence obtained from inquiry alone is not sufficient; thus, the auditor should supplement inquiry with other types of control tests—**observation** or **inspection** (which may include reperformance). Combining inquiry with inspection or reperformance typically provides more assurance than inquiry combined only with observation. The reliability of evidence obtained from inquiry depends on various factors, including the following:
- The competence, experience, knowledge, independence, and integrity of the person of whom the inquiry was made. The reliability of evidence is enhanced when the person possesses these attributes.
  - Whether the evidence was general or specific. Evidence that is specific is usually more reliable than evidence that is general.
  - The extent of corroborative evidence obtained. Evidence obtained from several entity personnel is usually more reliable than evidence obtained from only one person.
  - Whether the evidence was provided orally or in writing. Generally, evidence provided in writing is more reliable than evidence provided orally.

- .15 **Inspection.** The auditor conducts inspection tests by examining documents and records for evidence (such as the existence of initials or signatures) that a control activity was applied to those documents and records. System documentation, such as operations manuals, flowcharts, and job descriptions, may provide evidence of control design but do not provide evidence that controls are implemented and operating effectively. To use system documentation as part of the evidence of effective control activities, the auditor should obtain additional evidence on how the controls were applied.

Inspection is generally a reliable source of audit evidence and is frequently used in multipurpose testing. Because evidence of performance is documented, this type of test can be performed at any time. The evidence previously obtained from (1) the inspection of documents in walk-throughs (in which inspection is performed to a lesser extent than in sampling control tests) and (2) observation or inquiry tests may provide sufficient evidence of control effectiveness. However, the auditor should consider sampling items for inspection if additional audit evidence is needed.

Since documentary evidence generally does not provide evidence concerning how effectively the control was applied, the auditor generally should supplement inspection tests with observation and/or inquiry of persons applying the control. For example, the auditor generally should supplement inspection of initials on documents with observation and/or inquiry of the individual(s) who initialed the documents to understand the procedures they followed before initialing the documents. The auditor may also reperform the control being tested to determine if it was properly applied.

- .16 The auditor should select the type of control tests based on (1) the nature of the control to be tested and (2) the timing of the test and period covered by the control.
- .17 The **nature of the control** influences the type of evidence that is available. For example, if the control provides documentary evidence, the auditor may inspect the documentation. For other controls, documentation may not be available or relevant. For example, segregation-of-duties controls generally do not provide documentary evidence. In these circumstances, the auditor may obtain evidence about the effectiveness of the control's operation through observation or inquiry.
- .18 The **timing of the control test and the period covered by the control** influence the control test. The auditor should obtain evidence relating to the audit period. Unless it is documentary evidence, the auditor generally should obtain the evidence during the audit period, when sufficient corroborative evidence is most likely to be available. When the evidence relates to only a specific point in time, such as evidence obtained from observation, the auditor should obtain additional evidence that the control was effective during the entire audit period. For example, the auditor may observe the control in operation during the audit period and use inquiry and inspection of procedures manuals to determine that the control was in operation during the entire audit period. FAM 380.01 provides guidance concerning situations when new controls are implemented during the year. If the auditor tests controls after the audit period, the auditor should determine if any changes occurred between the end of the audit period and the time of the test. See FAM 350.22 for further discussion of interim testing of controls.

- .19 When selecting a particular control test from among equally effective tests, the auditor should select the most efficient test. For example, the auditor may find that inquiry, observation, and walk-throughs (tests of controls that do not involve sampling) provide sufficient evidence that a control was effective during the year and are the most efficient ways to test. When sampling is considered necessary, the auditor should consider performing multipurpose tests to enhance audit efficiency (see FAM 430 and FAM 450).

### **Determine the Extent of Control Tests**

- .20 After selecting the nature of control tests to be performed, the auditor should determine the extent of control tests (including IS controls). This determination is based on the information gathered in developing an understanding of internal control, the nature of the control to be tested, the nature and availability of evidence, and the auditor's determination of the amount of additional evidence needed. As the planned level of assurance increases, the auditor should seek more reliable or more extensive audit evidence.

For each control activity considered necessary to achieve the control objectives, the auditor should test the control activity to determine whether it is operating effectively to achieve the control objectives. Relevant financial reporting, budget, compliance, and operations controls generally should be tested to the same level of assurance. The extent of this testing is discussed in FAM 360 for nonsampling control tests and in FAM 450 for sampling control tests.

- .21 Controls that do not leave documentary evidence of existence or application generally cannot be tested with sampling procedures. When control activities, such as segregation of duties, do not leave documentary evidence, the auditor should test their effectiveness by observation and/or inquiry. For example, the auditor may obtain evidence about the proper segregation of duties by (1) direct observation of the control activities being applied during the audit period and (2) inquiry of the individual(s) involved about applying the activities at other times during the audit period. The appropriate extent of observation and inquiry is not readily quantifiable. To determine whether a control is effective, the auditor should consider whether sufficient evidence has been obtained to support the preliminary assessment of control risk as low (see FAM 370).

### **Determine the Timing of Control Tests**

- .22 The auditor should determine when to perform control tests. For efficiency, the auditor may perform most control testing on an interim basis that covers 9 or 10 months of the audit period and perform a roll-forward and limited testing for the remaining audit period. The auditor should obtain evidence about significant changes to those controls subsequent to the interim period (AU-C 330.12). Another approach is for the auditor to determine the actual population of transactions for the audit period through an interim date and estimate the transactions for the remaining audit period. A statistical sample can then be drawn that covers the entire audit period, with the bulk of testing completed during the interim period and the remaining items tested immediately after year-end. The auditor generally should overestimate the remaining items in the population so every item will have a chance of selection. An underestimate by

the auditor would leave some items outside the population sample and not subject to audit sampling, although they may be tested in other ways.

- .23 Management may implement changes to the entity's controls to make them more effective or efficient or to address deficiencies prior to the period end. If while performing an integrated audit, the auditor determines that the new controls achieve the related objectives and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness, the auditor does not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment in the financial statement audit, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate (AU-C 940.A80).

### **Determine the Nature, Extent, and Timing for Compliance with FFMIA**

- .24 If the auditor believes it is likely that the opinion on the financial statements will be unmodified (or that modifications will not relate to the entity's ability to prepare reliable financial statements or provide reliable financial information when needed), that internal control will be determined to be effective, and that the auditor will find no instances of noncompliance with legal and regulatory requirements, then the auditor should test the financial management systems' substantial compliance with the three FFMIA requirements. Also, the auditor may test for the systems' substantial compliance with the FFMIA requirements in other circumstances, as discussed in FAM 350.06.
- .25 When the auditor tests systems' substantial compliance with the FFMIA requirements, as discussed in FAM 350.04, the auditor generally should perform these tests concurrently with control tests described in FAM 360. The issues relevant to determining the nature, extent, and timing of control tests discussed in the FAM also apply to tests of systems' compliance with the FFMIA requirements.
- The auditor should read any management-developed documentation for its assertion about the systems' conformance with systems requirements in its FMFIA section 4 report<sup>3</sup> and any work it may have done for FFMIA compliance as described in OMB Circular No. A-123.
- .26 Management's documentation may be the basis for tests of the systems' substantial compliance with the three FFMIA requirements. If, for example, management provides the auditor with a checklist detailing the functions the systems are able to perform, the auditor generally should select some significant functions from the checklist and determine whether the systems actually perform them. The auditor may do this based on knowledge the auditor has acquired from gaining an understanding of the systems, as well as by additional observation, inquiry, inspection, and walk-throughs for control tests.
- If management has not provided documentation, the auditor may perform direct

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<sup>3</sup>FMFIA report on conformance with federal financial management system requirements. See 31 U.S.C. § 3512(d)(2).

testing of systems for compliance based on the requirements of FFMIA. If management is unable to provide any documentation, the auditor should inquire why there is no documentation and how management has determined whether it is in compliance. Lack of documentation often indicates that the systems do not comply substantially with the three FFMIA requirements.

## **Test the Components of Internal Control over Financial Reporting**

- .27 The auditor should identify and test those controls that are important to the auditor's conclusion about whether the entity has effective internal control over financial reporting (for integrated audits, also see AU-C 940.22) or for the report on internal control over financial reporting. The auditor generally should test the controls by a combination of observation, inquiry, or inspection. Per AU-C 940.A34, the auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls. However, the approach documented in the FAM does not allow for decreasing the amount of testing based solely on the evaluation of entity-level controls.
- .28 The auditor should evaluate the components of internal control over financial reporting and determine whether (1) the components are designed, implemented, and operating effectively and (2) the components are operating together in an integrated manner to achieve the entity's financial reporting objectives (for integrated audits, also see AU-C 940.23). The auditor assesses the five components and 17 related principles in the *Standards for Internal Control in the Federal Government* (known as the Green Book). In general, all components and principles are relevant for establishing an effective internal control system. See FAM 260 for additional discussion of the five components and 17 related principles of internal control. In rare circumstances, there may be an operating or regulatory situation in which management has determined that a principle is not relevant for the entity to achieve its objectives and address related risks. If management determines that a principle is not relevant, management should support that determination with documentation that includes the rationale of how, in the absence of that principle, the associated component could be designed, implemented, and operating effectively.

## **Control Environment**

- .29 The following principles are relevant to the auditor's evaluation of whether the control environment is designed, implemented, and operating effectively to achieve the entity's financial reporting objectives:
- The oversight body and management demonstrate a commitment to integrity and ethical values. An example of a procedure to perform in order to determine whether the oversight body and management have established an appropriate ethical tone and sound integrity and ethical values is to review the entity's policies, directives, and guidelines on ethical behavior and standards of conduct.
  - The oversight body oversees the entity's internal control over financial reporting.
  - Management establishes an organizational structure, assigns responsibility,

and delegates authority to achieve the entity's financial reporting objectives.

- Management demonstrates a commitment to recruit, develop, and retain competent individuals in alignment with the entity's financial reporting objectives.
- Management evaluates performance and holds individuals accountable for their internal control over financial reporting responsibilities.

### **Risk Assessment**

.30 The following principles are relevant to the auditor's evaluation of whether the entity's risk assessment is designed, implemented, and operating effectively to achieve the entity's financial reporting objectives:

- Management defines financial reporting objectives clearly to enable the identification of risks and defines risk tolerances related to these objectives.
- Management identifies, analyzes, and responds to risks related to achieving the financial reporting objectives.
- Management considers the potential for fraud when identifying, analyzing, and responding to risks related to achieving financial reporting objectives.
- Management identifies, analyzes, and responds to significant changes that could impact internal control over financial reporting.

### **Control Activities**

.31 The following principles are relevant to the auditor's evaluation of whether the entity's control activities relevant to the audit of internal control over financial reporting are designed, implemented, and operating effectively to achieve the entity's financial reporting objectives:

- Management designs control activities to achieve financial reporting objectives and responds to risks.
- Management designs the entity's information system and related control activities to achieve financial reporting objectives and respond to risks.
- Management implements control activities through policies.

### **Information and Communication**

.32 The following principles are relevant to the auditor's evaluation of whether the entity's information and communication, including the related business processes relevant to financial reporting, are designed, implemented, and operating effectively to achieve the entity's financial reporting objectives:

- Management uses quality information to achieve the entity's financial reporting objectives.
- Management internally communicates the necessary quality information to achieve the entity's financial reporting objectives.
- Management should externally communicate the necessary quality information to achieve the entity's financial reporting objectives.

### **Monitoring Activities**

- .33 The following principles are relevant to the auditor's evaluation of whether the entity's monitoring activities are designed, implemented, and operating effectively to achieve the entity's financial reporting objectives:
- Management establishes and operates monitoring activities to monitor the internal control system and evaluate the results.
  - Management should remediate identified deficiencies in internal control over financial reporting on a timely basis.



## **360 – Test IS Controls, Perform Nonsampling Control Tests, and Test Compliance with FFMIA**

- .01 As discussed in FAM 350, the auditor should perform tests of operating effectiveness for those controls that the auditor determined are designed and implemented effectively. (See FAM 380.02 if control activities are not effective in design during the entire audit period.) The auditor generally should
- request assistance from an IS controls auditor to test IS controls (FAM 360.03 through .10);
  - perform nonsampling control tests (the auditor generally should perform sampling control tests in the testing phase, as discussed in FAM 450—also see FAM 360.12 through .14); and
  - evaluate the results of nonsampling control tests (FAM 360.15 through .16).
- .02 The auditor also should design and conduct tests of the financial management systems' substantial compliance with the three requirements of FFMIA, if the auditor determines that such tests are necessary (see FAM 350.03 through .06 and 350.24 through .26). Many nonsampling control tests can also serve as tests for substantial compliance with the FFMIA requirements, especially the systems requirements and the SGL, although testing for accounting standards (U.S. GAAP) will include substantive procedures, done as part of the testing phase. After testing, the auditor may make a preliminary conclusion as to whether the entity's financial management systems comply substantially with the FFMIA requirements (see FAM 360.17).

### **Test IS Controls**

- .03 In the planning phase, the auditor identifies and documents the control activities included in the significant accounting applications that are dependent on information system processing. Such controls are often application and user controls. The auditor then identifies and documents the general controls implemented at the entitywide, system, and application levels that help ensure the effective operation of application and user controls included in the significant accounting applications. See FAM 240 for the specific requirements. The auditor also obtains an understanding of the design of the general controls identified to conclude tentatively whether IS controls are likely to be effective. See FAM 270 for the specific requirements. In the internal control phase, the auditor identifies the specific internal control activities that are likely to achieve the identified control objectives. See FAM 330, 340, and 350 for the specific requirements.
- As discussed in FAM 330.07, the auditor may use an SCE worksheet or equivalent to document the procedures discussed in FAM 330.03 through .06. The SCE worksheet groups potential misstatements and control objectives by accounting application (within each cycle), providing a format for performing and documenting the evaluation and testing of internal controls efficiently. For each of the specific controls to be evaluated and tested, as documented on the SCE worksheet or equivalent document, the auditor should distinguish which are IS controls. IS controls included on the SCE worksheet or equivalent document are often application and user controls. FAM 295 F provides more detail on the three

types of information system controls—general controls, application controls, and user controls. As discussed in FAM 295 F, the effectiveness of user controls typically depends on information system processing or the reliability of information that information systems produce.

The auditor should also identify other IS controls (application controls and general controls implemented at the entitywide, system, and application levels) upon which the effectiveness of the IS controls included on the SCE worksheet depends. The auditor should understand the design of all controls documented on the SCE worksheet, as well as the design of any other IS controls upon which the effectiveness of the IS controls identified on the SCE worksheet depends. As the auditor learns more about the design and implementation of the control activities included in the significant accounting applications that are dependent on information system processing and identifies the control activities that are most likely to achieve the control objectives, the auditor may identify other general controls implemented at the entitywide, system, and application levels that help ensure the effective operation of the IS controls on the SCE worksheet. As a result, the general controls identified during the internal control phase may differ from those identified during the planning phase.

The auditor should identify and test the general controls and application controls upon which the effectiveness of each IS control identified on the SCE worksheet depends. For example, if the IS control is the review of an exception report, the auditor would identify 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).

As discussed in FAM 350.07, the auditor generally should test only the control activities necessary to achieve the objective. For example, the entity may have several controls that are equally effective in achieving an objective. In such a case, the auditor generally should test the control activity that is efficient to test, considering such factors as (1) the extent to which a control achieves several control objectives and thereby reduces the number of controls that would ordinarily need to be tested; (2) the time that will be required to test the control; and (3) control dependencies, particularly for IS controls. A control dependency exists when the effectiveness of an internal control is dependent on the effectiveness of other internal controls. For example, when a dependency on information system processing exists, 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. An IS controls auditor may assist the auditor in identifying and understanding the design of application controls and general controls implemented at the entitywide, system, and application levels that help ensure the effective operation of the control activities that are dependent on information system processing. The auditor may also, based on risk, test different control activities from year to year in a recurring audit, but it does not change the auditor's responsibility to

identify the control activity, or combination of control activities, in the current-year audit that are necessary to achieve the control objective.

The auditor should document conclusions on the effectiveness of IS controls during the audit period. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity's use of information systems and 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.

- .04 If the auditor identifies IS controls on the SCE, the auditor should evaluate the effectiveness of related
- general controls at the entity-wide and system levels;
  - general controls at the application level; and
  - specific application controls, such as business process application controls, interface controls, data management system controls, and/or user controls, unless the IS controls that achieve the control objectives are general controls.

If controls are not effective, see FAM 360.07 and FAM 360.09.

- .05 The auditor should determine whether entity-wide and system-level general controls are designed, implemented, and operating effectively by
- identifying applicable general controls;
  - determining how those controls function, and whether they have been implemented; and
  - evaluating and testing the effectiveness of the identified controls.

The auditor generally should use knowledge obtained in the planning phase. The auditor should document the understanding of general controls and should conclude on whether such controls are designed, implemented, and operating effectively.

## Tests of General Controls at the Entity-Wide and System Levels

- .06 The auditor may test general controls through a combination of procedures, including observation, inquiry, inspection (which includes a review of documentation on systems and procedures), and reperformance using appropriate test software. Although sampling is generally not used to test general controls, the auditor may use sampling to test certain controls, such as those involving approvals.
- .07 If general controls are not designed, implemented, or operating effectively, the auditor will generally be unable to obtain satisfaction that application controls are effective.<sup>1</sup> In such instances, the auditor should (1) determine and document the nature and extent of risks resulting from ineffective general controls, (2) identify and test any manual controls that achieve the control objectives that the IS controls in the SCE worksheet or equivalent document were unable to achieve,

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<sup>1</sup>Refer to the FISCAM for further information.

and (3) see FAM 580 for classifying and reporting control deficiencies.

If manual controls do not achieve the control objectives, the auditor should determine whether any specific IS controls are **designed** to achieve the objectives. If not, the auditor should develop appropriate findings principally to provide recommendations to improve internal control. If specific IS controls are designed to achieve the objectives, but are in fact ineffective because of poor general controls, testing would typically not be necessary, except to support findings.

## Tests of General Controls at the Application Level

- .08 If the auditor reaches a favorable conclusion on general controls at the entity-wide and system levels, the auditor should evaluate and test the effectiveness of general controls for those software programs, or applications, within which application controls or user controls are to be tested. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in assessing these controls.
- .09 If general controls are not operating effectively within the application, application controls and user controls generally will be ineffective.<sup>2</sup> In such instances, the audit team should discuss the nature and extent of risks resulting from ineffective general controls. The auditor should determine whether to proceed with the evaluation of application controls and user controls.

## Tests of Application Controls and User Controls

- .10 The auditor, generally with IS controls auditor assistance, should perform tests of those application controls and user controls necessary to achieve the control objectives where the entity-wide, system, and application-level general controls were determined to be effective.

## Perform Nonsampling Control Tests

- .11 The auditor should (1) develop audit procedures that incorporate the nature, extent, and timing of planned nonsampling control tests, including tests for compliance with FFMIA for CFO Act agencies, and (2) perform nonsampling control tests according to the audit procedures. When testing controls, the auditor should determine whether adequate segregation of duties exist as indicated in FAM 360.13 through .14.

Some important controls do not operate frequently, but the auditor may need to test these controls. For example, some controls may be performed only once a year, such as controls over the year-end closing process, and can only be tested once. Still other controls may operate biweekly or weekly, such as controls over processing the payroll that may operate 26 or 52 times a year. Table I below provides guidance in the testing of small populations associated with less frequently operating controls. For less frequently operating controls, the effect of other sources of evidence is often greater than for more frequently operating controls. Some examples of other implicit sources of evidence in an audit of the

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<sup>2</sup>Refer to the FISCAM for further information.

financial statements include inherent risk assessments, assessments of design and implementation, past experience, walk-throughs, corroborating inquiries, other control testing, knowledge about other balances, competence of personnel, systems knowledge, etc.

Table I: Testing Operating Effectiveness of Small Populations

| Control frequency and population size |      | Items to test |
|---------------------------------------|------|---------------|
| Quarterly                             | (4)  | 2             |
| Monthly                               | (12) | 2-4           |
| Semimonthly                           | (24) | 3-8           |
| Weekly                                | (52) | 5-9           |

## Perform Segregation-of-Duties Control Tests

- .12 Segregation-of-duties controls are designed to reduce the opportunities for any person to be in a position both to perpetrate and to conceal misstatements, especially fraud, in the normal course of duties. Typically, an entity achieves adequate segregation of duties by establishing controls (such as segregating asset custody from recordkeeping functions) to prevent any person from having uncontrolled access to both assets and related records.
- .13 The auditor should test segregation of duties in the situations described in FAM 330.08. The auditor may use the following procedures to test segregation-of-duties controls:
  - a. Identify the assets to be controlled through the segregation of duties.
  - b. Identify the individuals who have authorized access (direct or indirect) to the assets. An individual with direct access is authorized to handle the assets directly (such as during the processing of cash receipts). An individual with indirect access is authorized to prepare documents that cause the release or transfer of assets (such as preparing the necessary forms to request a cash disbursement or transfer of inventory).
  - c. For each individual with authorized access to assets, determine whether there are sufficient asset access controls. Asset access controls are those controls that are designed to provide assurance that actions taken by individuals with authorized access to assets are reviewed and approved by other individuals. For example, an approval of an invoice for payment generally provides asset access controls (relating to cash) over those individuals authorized to prepare supporting documentation for the transaction. If information systems provide access to assets, the auditor should design tests of IS controls to identify (1) individuals (including information systems personnel) who may use the computer to obtain access and (2) asset access controls over such individuals.
  - d. For individuals with authorized access to assets over which asset access controls are insufficient, determine whether such individuals can affect any recording of transactions in the accounting records. If so, segregation of

duties is insufficient, unless such access to accounting records is controlled. For example, the person who processes cash receipts may also be able to record entries in the accounting records. Such a person may be in a position to manipulate the accounting records to conceal a shortage in the cash account, unless another individual reviews all accounting entries that the person made (or should have been made).

In an IS accounting system, access to assets frequently provides access to records. For example, generation of a check may automatically record a related accounting entry. In such circumstances, a lack of asset access controls would result in inadequate segregation of duties, and the auditor should determine whether other controls would mitigate the effects of this lack of asset access control.

## **Evaluate the Results of Nonsampling Control Tests**

- .14 The auditor should investigate and understand the reasons for any deviations from control activities noted during nonsampling control tests. The auditor may find, for example, that significant subpopulations were not subject to controls or that controls were not applied during a specific period during the year. In such instances, the auditor may determine whether controls are effective for at least some parts of the population. For example, an otherwise effective control may not have been applied effectively in 1 month due to personnel turnover. For all but that month, the auditor may assess controls as effective and reduce related substantive testing. For the 1 month that controls were not effective, the auditor may increase substantive testing, if these tests are sufficient to reduce detection risk. The auditor also should determine whether other controls achieve the related control objective(s).
- .15 Additionally, the auditor should gather sufficient evidence to report the control deficiency, as discussed in FAM 580.44 through .72.

## **Test Compliance with FFMIA**

- .16 The auditor may make preliminary conclusions as to whether the entity's financial management systems comply substantially with federal financial management systems requirements, federal accounting standards (U.S. GAAP), and the SGL at the transaction level. However, the auditor should not form a final conclusion as to compliance, especially with accounting standards, until the auditor completes substantive procedures (see FAM 470).

## **370 – Assess Internal Control on a Preliminary Basis**

- .01 Based on the evaluation of the design and implementation of internal control and the results of nonsampling control tests, the auditor should preliminarily assess the effectiveness of internal control during the period (for a report on internal control and for determining the risk of material misstatement used to determine the nature, extent, and timing of further audit procedures) and as of the end of the period (if the auditor is expressing an opinion on internal control as of that point in time). Assessing the effectiveness of IS controls is discussed in FAM 370.03 through .05. Assessing the effectiveness of each type of control—financial reporting (including safeguarding), budget, compliance, and operations—is discussed in FAM 370.06 through .14.
- .02 To assess the effectiveness of internal control, the auditor determines whether internal control provides reasonable assurance that control objectives are achieved. Internal control only provides reasonable assurance that misstatements, losses, or noncompliance, material in relation to the financial statements, would be prevented, or detected and corrected, during the period under audit. For each control objective that is not achieved, the auditor should obtain sufficient (1) information to determine whether the deficiency is a material weakness, significant deficiency, or other control deficiency and to report any deficiencies in the auditor's report or separate management report (see FAM 580.44 through .72) and (2) evidence to support the preliminary assessment of the effectiveness of internal control and the risk of material misstatement.

### **Information System Results**

- .03 Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in assessing these controls. Based on the procedures performed, the auditor and IS controls auditor should discuss conclusions on the effectiveness of IS controls and reach agreement. The auditor should (1) incorporate the conclusions into the audit documentation for each IS control tested and (2) perform tests on the manual aspects of application controls (e.g., manual follow-up on items in an exception report).
- .04 If the auditor determines that IS controls are effective, the auditor may also ask the IS controls auditor to identify any IS controls within the software programs, or applications, tested that the auditor did not previously identify using the above procedures. For example, such IS controls might achieve control objectives not otherwise achieved through manual controls or might be more efficient or effective to test than manual controls.

The IS controls auditor may assist the auditor in determining the efficiency and effectiveness of searching for and testing additional IS controls. The auditor should document these decisions, including a description of the expected nature, extent, and timing of the IS controls auditor's work.
- .05 The auditor and IS controls auditor should work together to document the procedures for evaluating and testing the effectiveness of IS controls and the results of this work.

## Financial Reporting Controls

- .06 Based on audit procedures performed but before sampling control tests,<sup>1</sup> if any, the auditor generally should form a preliminary conclusion about (1) the effectiveness of financial reporting controls as of the end of the period—when the auditor is providing an opinion on internal control—and (2) the assessed level of control risk and the risk of material misstatement during the period for each significant assertion in each significant line item or account. The risk of material misstatement is the risk that prior to the application of substantive audit procedures, a material misstatement exists in a financial statement assertion.
- The risk of material misstatement consists of the risks that (1) a financial statement assertion is susceptible to material misstatement (inherent risk) and (2) such material misstatement, either individually or when aggregated with other misstatements, is not prevented, or detected and corrected, on a timely basis by the entity's internal control (control risk). The auditor uses professional judgment in assessing inherent risk, control risk, and the risk of material misstatement.
- .07 **Preliminary assessment of control risk.** For **each significant assertion** in each significant line item or account, the auditor should assess control risk at one of three levels:
- **Low:** The auditor believes that controls **will** prevent or detect any aggregate misstatements in excess of performance materiality that could occur in the assertion.
  - **Moderate:** The auditor believes that controls **will more likely than not** prevent or detect any aggregate misstatements in excess of performance materiality that could occur in the assertion.
  - **High:** The auditor believes that controls **will more unlikely than likely** prevent or detect any aggregate misstatements in excess of performance materiality that could occur in the assertion.
- .08 In assessing control risk in a line item/account assertion, the auditor generally should consider the aggregate magnitude of misstatements that might not be prevented, or detected and corrected, in significant accounting applications that affect the line item or account. For example, the cash receipts, cash disbursements, and payroll accounting applications typically affect the cash account. Accordingly, the auditor should evaluate the risk that aggregate misstatements could arise from a combination of those accounting applications and not be prevented, or detected and corrected, by controls.
- .09 **Preliminary assessment of the risk of material misstatement.** In assessing the risk of material misstatement, the auditor should evaluate the likelihood that a material misstatement would occur (inherent risk) and not be prevented or detected on a timely basis by the entity's internal control (control risk). The auditor should base this preliminary assessment of the risk of material misstatement on the auditor's assessment of inherent risk and control risk. For

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<sup>1</sup>The auditor may assess the risk of material misstatement on a preliminary basis at an earlier point in the audit, if preferred. This may be particularly appropriate for a recurring audit where the auditor has an understanding of the design of the control environment, entity risk assessment, information and communication, and monitoring components of internal control.



**each significant assertion** in each significant account, the auditor should assess **the risk of material misstatement** at one of three levels:

- **Low:** Based on the evaluation of inherent risk and control risk, but prior to the application of substantive audit procedures, the auditor believes that any aggregate misstatements in the assertion do not exceed performance materiality.
- **Moderate:** Based on the evaluation of inherent risk and control risk, but prior to the application of substantive audit procedures, the auditor believes that it is **more likely than not** that any aggregate misstatements in the assertion do not exceed performance materiality.
- **High:** Based on the evaluation of inherent risk and control risk, but prior to the application of substantive audit procedures, the auditor believes that it is **more unlikely than likely** that any aggregate misstatements in the assertion do not exceed performance materiality. As a result, the auditor should obtain most, if not all, audit evidence from substantive procedures.

- .10 The minimum substantive assurance from substantive procedures varies directly with the risk of material misstatement. In other words, as the risk of material misstatement increases, so does the minimum substantive assurance level. FAM 470 discusses the assurance level in more detail. The auditor should document the preliminary assessment of control risk and the risk of material misstatement in the LIRA form or equivalent.

## Budget Controls

- .11 When forming conclusions on the effectiveness of internal control related to budget execution, the auditor should evaluate the impact of any uncorrected misstatements noted in the proprietary accounts and should determine any impact on the budgetary amounts. If the budgetary amounts are also misstated, the auditor should determine whether these misstatements indicate deficiencies in internal control related to budget execution. If audit evidence indicates that internal control might not provide reasonable assurance that the entity executed transactions in accordance with budget authority, the auditor should discuss the legal implications with the Office of the General Counsel (OGC) and document the conclusions.

## Compliance Controls

- .12 Based on the results of compliance control tests and other audit procedures, the auditor should
- conclude whether the entity's internal control provides reasonable assurance that the entity complied with the significant provisions of applicable laws, regulations, contracts, and grant agreements, noncompliance with which could have a material effect on the financial statements, and
  - report deficiencies in compliance controls that come to the auditor's attention (see FAM 580.44 through .72).

If compliance controls are effective in preventing, or detecting and correcting, noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements during the period, the extent of compliance

testing can be less than if such controls were not effective, as discussed in FAM 460.

### **Operations Controls**

- .13 If the results of control tests indicate that operations controls were not effective during the period, the auditor should not place reliance on the ineffective operations controls when designing other audit procedures. See FAM 580.44 through .72 regarding reporting significant deficiencies.

### **Reevaluation of Control Risk and the Risk of Material Misstatement**

- .14 After completing the testing phase, discussed in FAM 400, the auditor should reevaluate the preliminary assessment of control risk and the risk of material misstatement for financial reporting controls and control effectiveness for budget, compliance, and operations controls. If the test results are contrary to the preliminary assessment (e.g., control risk assessed at low, but the controls being tested were not operating effectively), the auditor should reevaluate the adequacy of the audit procedures performed and perform additional procedures as necessary.

## **380 – Other Considerations**

### **Partial-Year Controls**

- .01 The auditor should test controls for the particular time or throughout the period for which the auditor intends to rely on those controls (AU-C 330.11). In certain situations, such as when new controls are implemented during the year, the auditor may elect to test controls only for the period during which the new controls were operating. In such situations, the extent of control testing should remain similar but be concentrated over the period that the new controls were in place.

For any portion of the audit period for which financial reporting, budget, and compliance controls were not tested, the auditor should design compliance and substantive procedures as if these controls were ineffective. However, the auditor should evaluate whether substantive procedures alone can mitigate the risk of material misstatement or provide sufficient appropriate audit evidence for this period, as discussed in AU-C 330.08.

### **Planned Changes in Controls**

- .02 The auditor may become aware of an entity's plans to implement new accounting or control systems after the audit period ends. Even though new systems or controls are planned, the auditor should evaluate IS controls over the systems in operation to conclude on whether they are designed, implemented, and operating effectively through the end of the audit period to
- assess the risk of material misstatement;
  - determine the nature, extent, and timing of further audit procedures;
  - provide support for the report or opinion on internal controls; and
  - recommend any improvements to the current system that should be considered in designing the new systems or controls.

During the current audit, the auditor may review controls designed into the new system and generally should bring any identified deficiencies to the attention of entity management.

## **390 – Documentation**

- .01 In addition to preparing an audit plan with control testing audit procedures and other documentation relevant to the internal control phase, the auditor should prepare the documents described in FAM 390.05 through .08 or their equivalent.
- .02 The auditor may prepare written guidance for the rest of the audit team, either within or accompanying the audit procedures, to explain possible exceptions, their nature, and why they might be important. This also may help the auditor focus on key matters, more readily determine which exceptions are important, and identify significant exceptions.
- .03 The auditor also should document the results of the audit procedures performed and the audit evidence obtained.
- .04 As the audit work is performed, the auditor may become aware of possible significant deficiencies or other matters that should be communicated to the entity, including those charged with governance. The auditor should document and communicate these as described in FAM 290.02 and FAM 580.63 through .72.

### **Cycle Memorandums and Flowcharts**

- .05 The auditor should document the understanding gained of each of the five components of internal control (control environment, entity risk assessment, information and communication, control activities, and monitoring), including information system processing. The auditor should prepare sufficient documentation to clearly describe the accounting system. The auditor should include in this documentation evidence about implementation of the controls. For each significant cycle, the auditor should prepare a cycle memorandum or equivalent. Also, the auditor may prepare a flowchart of the cycle and component accounting application(s).

Flowcharts provide a good mechanism to document the process and the flow of transactions through the system. However, the auditor generally should avoid extreme detail, which makes the charts confusing and hard to follow. Complex systems, particularly those involving information technology, may be difficult to understand without a flowchart. To the extent required as described above, the auditor should use the following documents or equivalents to document relevant accounting systems information for financial reporting controls:

#### **A cycle memorandum**

- identifies the cycle transactions, each significant accounting application, and each significant financial management system included in the cycle;
- documents the auditor's understanding of the information system processing included in the significant accounting applications, including the organizational units and financial management systems involved;
- describes relationships with other cycles;
- identifies financial statement line items, relevant assertions, and general ledger accounts included in the cycle;

- describes the operating policies and procedures relating to the processing of cycle transactions (see FAM 320.03);<sup>1</sup> and
- identifies major internal controls (overview only).

For CFO Act agencies, the auditor may include in the cycle memorandum information on FFMIA requirements considered to this point, such as systems requirements and the SGL.

**Flowcharts** complement the related cycle memorandum and summarize the significant transaction flows in terms of

- input and report documents,
- processing steps,
- files used,
- organizational units involved,
- information systems
- interfaces with other cycles and accounting applications.

Although the auditor may have gathered information on control activities when preparing flowcharts, the auditor should document these control activities in the SCE worksheet or equivalent. Major controls may be included in the flowchart.

- .06 The auditor should document the understanding of relevant compliance and operations control systems in a memorandum and may prepare a flowchart addressing each point discussed in FAM 320.05 through .07.

## SCE Worksheet

- .07 The auditor should document the evaluation of specific control activities in the SCE worksheet or equivalent. The auditor should document control tests in the control test audit plan and in accompanying documents. The auditor should also document any IS control tests, as discussed in FAM 370.05. FAM 395 G presents an example of a completed SCE worksheet.

## Updating the LIRA Form

- .08 The auditor should update the LIRA form or equivalent by completing the internal control phase columns, as illustrated in FAM 395 H. The LIRA form should also include the results of risk assessment procedures and evaluation of the design and implementation of controls for risks for which the auditor has judged that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures, as discussed in FAM 310.02 and AU-C 315.31 and AU-C 315.A133 through .A136.

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<sup>1</sup>Specific relevant control activities for significant assertions are documented later in the SCE worksheet or equivalent, after related control objectives have been identified (see FAM 330.02 through .11).

## 395 A – Typical Relationships of Accounting Applications to Line Items/Accounts

This section illustrates the typical relationships between accounting applications and line items or accounts. For example, sources of significant accounting entries to cash typically include the cash receipts, cash disbursements, payroll, and cash accounting applications. For each significant line item or account, the auditor should develop an understanding of how potential misstatements in significant accounting applications could affect the significant assertions of the related line item or account. In turn, the auditor should identify the control objectives and relevant control techniques to achieve those objectives. The relationship between accounting applications and line item assertions is discussed in FAM 330.04 through .07.

|  | Line Items / Accounts |                        |           |          |             |         |          |             |
|--|-----------------------|------------------------|-----------|----------|-------------|---------|----------|-------------|
|  | Cash or<br>FBWT       | Accounts<br>Receivable | Inventory | Property | Liabilities | Revenue | Expenses | Obligations |
| <b>Transaction-related accounting applications</b>       |                       |                        |           |          |             |         |          |             |
| Billing  |                       | X                      |           |          |             | X       |          |             |
| Cash Receipts  | X                     | X                      |           |          |             | X       |          |             |
| Purchasing   |                       |                        | X         | X        | X           |         | X        | X           |
| Cash Disbursements                                       | X                     |                        | X         | X        | X           |         | X        | X           |
| Payroll  | X                     |                        |           |          | X           |         | X        | X           |
| <b>Line item/account-related accounting applications</b> |                       |                        |           |          |             |         |          |             |
| Cash   | X                     |                        |           |          |             |         |          |             |
| Accounts Receivable                                      |                       | X                      |           |          |             |         |          |             |
| Inventory  |                       |                        | X         |          |             |         |          |             |
| Property   |                       |                        |           | X        |             |         |          |             |
| Liabilities  |                       |                        |           |          | X           |         |          |             |
| Obligations  |                       |                        |           |          |             |         |          | X           |

## **395 B – Financial Statement Assertions, Potential Misstatements, and Control Objectives**

This section lists potential misstatements that could occur in each financial statement assertion within an accounting application, together with related control objectives. The auditor may tailor this information to the accounting application and to the entity and may add other control objectives or subobjectives. The assertion, potential misstatement, and control objective illustrated in this section may be used in preparing the first, fourth, and fifth columns of the SCE worksheet, which is illustrated in FAM 395 G. However, this section is provided as a reference and does **not** require completion as a form.

| Assertion                      | Potential misstatement   | Control objective  |
|--------------------------------|--|--|
| <b>Existence or occurrence</b> | <b>Transaction related</b>   |  |
|                                | <b>Occurrence/validity:</b>  |  |
|                                | 1. Recorded transactions and events do not represent economic events that actually occurred or do not pertain to the entity. | 1a. Recorded transactions, underlying events, and related processing procedures are authorized by federal laws, regulations, contracts, and grant agreements and management policy.<br><br>1b. Appropriate individuals approve recorded transactions in accordance with management's general or specific criteria.<br><br>1c. Recorded transactions represent events that actually occurred, are properly classified, and pertain to the entity. |
|                                | <b>Cutoff:</b>   |  |
|                                | 2. Transactions are recorded in the current period, but the related economic events occurred in a different period.          | 2. Transactions recorded in the current period represent economic events that occurred during the current period.  |
|                                | <b>Summarization:</b>  |  |
|                                | 3. Transactions are summarized improperly, resulting in an overstated total.   | 3. The summarization of recorded transactions is not overstated.   |

| Assertion                      | Potential misstatement   | Control objective   |
|--------------------------------|--|---|
| <b>Existence or occurrence</b> | <b>Line item/account related</b>   |   |
|                                | <b>Substantiation:</b><br><br>4. Recorded assets and liabilities do not exist at a given date.   | 4a. Recorded assets and liabilities exist at a given date.<br><br>4b. Recorded assets and liabilities of the entity, at a given date, are supported by appropriate detailed records that are accurately summarized and reconciled to the account balance.<br><br>4c. Access to assets, critical forms, records, and processing and storage areas is permitted only in accordance with laws, regulations, and management policy. |
| <b>Completeness</b>            | <b>Transaction related</b>   |   |
|                                | <b>Transaction completeness:</b><br><br>5. Valid transactions are not recorded or are improperly classified.<br><br><b>Cutoff:</b><br><br>6. Economic events occur in the current period, but the related transactions are recorded in a different period.<br><br><b>Summarization:</b><br><br>7. Transactions are summarized improperly, resulting in an understated total. | 5. All valid transactions are recorded and classified properly.<br><br>6. All economic events that occurred in the current period are recorded as transactions in the current period.<br><br>7. The summarization of recorded transactions is not understated.  |



| Assertion                     | Potential misstatement   | Control objective  |
|-------------------------------|--|--|
| <b>Completeness</b>           | <b>Line item/account related</b>   |  |
|                               | <b>Account completeness:</b><br><br>8. Assets and liabilities of the entity exist but are omitted from the financial statements.   | 8. All accounts, assets, and liabilities that exist as of the reporting date that belong in the financial statements are included in the financial statements. There are no undisclosed assets or liabilities. |
| <b>Accuracy/valuation</b>     | <b>Transaction related</b>   |  |
|                               | <b>Accuracy:</b><br><br>9. Transactions are recorded at incorrect amounts.   | 9. Transactions are recorded at correct amounts.   |
|                               | <b>Line item/account related</b>   |  |
|                               | <b>Valuation:</b><br><br>10. Assets and liabilities included in the financial statements are valued on an inappropriate basis.<br><br><b>Measurement:</b><br><br>11. Revenues and expenses included in the financial statements are measured improperly. | 10. Assets and liabilities included in the financial statements are valued on an appropriate valuation basis.<br><br>11. Revenues and expenses included in the financial statements are measured properly.     |
| <b>Rights and obligations</b> | <b>Line item/account related</b>   |  |
|                               | <b>Ownership:</b><br><br>12. Recorded assets are owned by others because of sale, consignment, or other contractual arrangements.  | 12. The entity owns (i.e., has valid title to) recorded assets.  |

| Assertion                          | Potential misstatement   | Control objective  |
|------------------------------------|--|--|
| <b>Rights and obligations</b>      | <b>Line item/account related</b>   |  |
|                                    | <b>Rights:</b><br><br>13. The entity does not have certain rights to recorded assets because of liens, pledges, or other restrictions.<br><br><b>Obligations:</b><br><br>14. The entity does not have an obligation for recorded liabilities at a given date.  | 13. The entity has the rights to recorded assets at a given date.<br><br><br><br><br><br><br><br><br><br>14. Liabilities are the entity's obligations at a given date.   |
| <b>Presentation and disclosure</b> | <b>Line item/account related</b>   |  |
|                                    | <b>Account classification:</b><br><br>15. Accounts or the transactions they accumulate are not properly classified and described in the financial statements.<br><br><b>Consistency:</b><br><br>16. The current period financial statement components are based on accounting principles different from those used in the prior periods presented. | 15. Accounts and all the transactions they accumulate are properly classified and described in the financial statements.<br><br><br><br><br><br><br><br><br><br>16. The financial statement components are based on accounting principles that are applied consistently from period to period. |

| Assertion                          | Potential misstatement   | Control objective  |
|------------------------------------|--|--|
| <b>Presentation and disclosure</b> | <b>Line item/account related</b>   |  |
|                                    | <b>Disclosure:</b><br><br>17. Information needed for fair presentation in accordance with U.S. generally accepted accounting principles (U.S. GAAP) is not disclosed in the financial statements or in the related footnotes. <sup>1</sup> | 17. The financial statements and related footnotes contain all information needed for fair presentation in accordance with U.S. GAAP.  |
|                                    | <b>Transaction related</b>   |  |
|                                    | <b>Segregation of duties:</b> <sup>2</sup><br><br>18. The entity is exposed to loss of assets and various potential misstatements, including certain of those above, as the result of inadequate segregation of duties.                    | 18. Persons do not have uncontrolled access to both assets and records; they are not assigned duties to put them in a position that would allow them to both commit and conceal errors or fraud. |

<sup>1</sup>Based on inherent risk, the auditor may choose to add an additional potential misstatement and control objective regarding the overstatement of disclosure information. The potential misstatement may be worded as “Information disclosed in the financial statements did not occur or does not pertain to the rights and obligations of the entity.” The control objective may be worded as “All information disclosed in the financial statements actually occurred and pertains to the rights and obligations of the entity.”

<sup>2</sup>Segregation-of-duties controls are a type of safeguarding control and are often crucial to the effectiveness of controls, particularly over liquid, readily marketable assets that are highly susceptible to theft, loss, or misappropriation. Such controls are designed to reduce the opportunities for any person to be in a position to both commit and conceal fraud. The lack of segregation-of-duties controls may be pervasive and affect several misstatements. *Financial Audit Manual* 330.08 discusses when the auditor should test segregation-of-duties controls.

## **395 C – Typical Control Activities**

### **Authorization**

- .01 Authorization controls are designed to provide reasonable assurance that (1) transactions, (2) events from which they arise, and (3) procedures under which they are processed are authorized in accordance with laws, regulations, contracts, grant agreements, and management policy. Typical authorization controls include
- documented policies establishing events or transactions that the entity is authorized to engage in by law, regulation, contract, grant agreement, or management policy;
  - documented policies and procedures exist for processing transactions in accordance with laws, regulations, contracts, grant agreements, or management policy; and
  - master files that include only authorized employees, customers, or suppliers.

### **Approval**

- .02 Approval controls are designed to provide reasonable assurance that appropriate individuals approve recorded transactions in accordance with management's general or specific criteria. Typical approval controls occur when the following occurs:
- Transactions are approved by persons having the authority to do so (such as the specific approval of purchases by the procurement officer or other designated individual with procurement authority) in accordance with established policies and procedures.
  - Transactions are compared with predetermined expectations (invoice terms are compared with agreed-upon prices, input is checked for valid data type for a particular field, etc.), and exceptions are reviewed by someone authorized to approve them.
  - Transactions are compared with approved master files (such as approved customer credit limits or approved vendors) before approval or acceptance, and exceptions are reviewed by someone authorized to approve them or correct the situation.
  - Key records are matched before a transaction is approved (such as the matching of purchase order, receiving report, and vendor invoice records before an invoice is approved for payment).
  - Before acceptance, changes to data in existing files are independently approved, evidenced by either documentary or online approval of input before processing.

### **Segregation of Duties**

- .03 Segregation-of-duties controls are designed to reduce the opportunities for someone to both cause and conceal errors or fraud. Typically, an entity achieves

adequate segregation of duties by establishing controls (such as segregating asset custody from recordkeeping functions) to prevent any person from having uncontrolled access to both assets and records. See FAM 330.08 and 360.13 through .14 for additional discussions of segregation-of-duties controls.

## Design and Use of Documents and Records

- .04 Controls over the design and use of records help provide reasonable assurance that transactions and events are recorded. Such controls typically include the following:
- Prenumbered forms are used to record all of an entity's transactions, and accountability is maintained for the sequence of all numbers used. (For example, prenumbered billing documents, vouchers, purchase orders, etc., are accounted for in numerical sequence when they are used, and any numbers missing from the sequence are investigated.)
  - Receiving reports, inspection documents, purchase orders, and other information are matched with billing notices, such as vendor invoices, or other documents used to record delivered orders and related liabilities to provide assurance that all and only valid transactions are recorded.
  - Transaction documents (such as vendor invoices or shipping documents) are stamped with the date and tracked (through periodic supervisory reviews) to provide assurance that transactions are recorded.
  - Source documents are canceled after processing (for example, invoices are stamped, perforated, or written on after they are paid) to provide assurance that the same documents will not be reused and will not result in the entity recording transactions more than once. Also, only original documents are used to process transactions.

## Safeguards over Access to and Use of Assets and Records

- .05 Access controls are designed to protect assets and records against physical harm, theft, loss, misuse, or unauthorized alteration. These controls restrict **unauthorized** access to assets and records. The auditor should determine whether to evaluate segregation of duties of persons who have **authorized** access to assets and records based on FAM 330.08. Typical access controls include the following:
- Cash receipt totals are recorded before cash is deposited.
  - Secured facilities (locked rooms, fenced areas, vaults, etc.) are used. Access to critical forms and equipment (such as check signing machines and signature stamps) is limited to authorized personnel.
  - Access to information system programs and data files is restricted to authorized personnel. (For example, manual records, computer terminals, and backup files are kept in secured areas to which only authorized persons can gain access. Access is restricted by logical access controls.)
  - Assets and records are protected against physical harm. (For example, intruder alarms, security guards, fire walls, a sprinkler system, etc., are used to prevent intentional or accidental destruction of assets and records.)

- Incoming and outgoing assets are counted, inspected, and received or disposed/transferred/sold only on the basis of proper authorization (such as a purchase order, contract, or shipping order) in accordance with established procedures.
- Procedures provide reasonable assurance that current files can be recovered in the event of a computer failure. (For example, the entity has implemented a backup and recovery plan, such as using on-premises or off-premises file backup, off-site storage of duplicate programs and operating procedures, and standby arrangements to use a second processing facility if the entire data center is destroyed.)
- Access to critical forms and records is restricted. (For example, secured conditions are established and maintained for manual records and media used to access assets, such as blank checks or forms for the release of inventory.)

## Independent Checks

- .06 Controls are designed to provide independent checks of the validity, accuracy, and completeness of processed data. Procedures that are typical of this category of controls include the following:
- Calculations, extensions, additions, and accounting classifications are independently reviewed. (For example, arithmetic on vouchers is independently recomputed—either manually or by computerized systems—and transactions and accounting classifications are subsequently reviewed.)
  - Assets on hand are periodically inspected and counted, and the results are compared with asset records. (For example, inventories are inspected and physically counted at the end of each year and compared with inventory records.)
  - Subsidiary ledgers and records are reconciled to general ledgers.
  - The entity promptly follows up on complaints from vendors, customers, employees, and others.
  - Management reviews performance reports. (For example, the warehouse manager reviews performance reports on the accuracy and timeliness of fulfilling shipping orders and recording them in the sales processing system.)
  - Data from different sources are compared for accuracy and completeness. (For example, the cash journal entry is compared with the authenticated bank deposit slip and with the detailed listing of cash receipts prepared independently when mail was opened, and units billed are compared with units shipped.)
  - Actual operating results (such as personnel cost or capital expenditures for a particular organizational component or an entity as a whole) are compared with approved budgets, and variances are explained.

## **Valuation Controls of Recorded Amounts**

- .07 Controls in this category are designed to provide reasonable assurance that assets are accurately valued at appropriate amounts. Typical valuation controls are as follows:
- Periodic evaluation of the condition and marketability of assets. (For example, inventory is periodically reviewed for physical damage, deterioration, or obsolescence, or receivables are evaluated for collectability.)
  - Recorded data are compared with information from an independent third party. (For example, recorded cash is reconciled to bank statements, and suppliers' accounts are reconciled to monthly statements from suppliers.)
  - Assessed values (such as independent appraisals of assets) are compared with the accounting records.

## **Summarization of Accounting Data**

- .08 Controls in this category are designed to provide reasonable assurance that transactions are accurately summarized and that any adjustments are valid. Typical controls in this category include the following:
- The sources of summarized data (such as ledgers, journals, and/or other records) are compared with the underlying subsidiary records and/or documents before the data are accepted for inclusion in summarized records and reports. (For example, when Fund Balance with Treasury (FBWT) in the general ledger is reconciled to the balance from Treasury, any necessary journal entries are compared to source documents, and the summaries of journal entries are compared to the individual journal entries before the summarized entries are posted to the general ledger.)
  - Procedures are followed to check the completeness and accuracy of data summarization, and exceptions are reviewed and resolved by authorized persons. (For example, batch totals are compared with appropriate journals, hash totals are compared at the beginning and end of processing, and totals passed from one system or software program/application to another are compared.)

## **Rights and Obligations Controls**

- .09 Controls in this category are designed to provide reasonable assurance that (1) the entity owns recorded assets, with the ownership supported by appropriate documentation; (2) the entity has the rights to its assets at a given date; and (3) recorded liabilities reflect the entity's obligations at a given date. Procedures that are typical of this category of controls include the following:
- Policies and procedures are documented (such as policy, procedures, and training manuals, together with organization charts) for initiating transactions and for identifying and monitoring those transactions and accounts warranting attention with respect to ownership.
  - Policies and procedures are documented for initiating and monitoring transactions and accounts related to obligations.

- Significant transactions require the approval of senior management.
- Reported results and balances are compared with plans and authorizations.

## **Presentation and Disclosure Controls**

- .10 Controls in this category are designed to provide reasonable assurance that (1) accounts are properly classified and described in the financial statements, (2) the financial statements are prepared in conformance with U.S. GAAP, and (3) footnotes contain all information needed for fair presentation. Procedures that are typical of this category of controls include the following:
- Policies and procedures are documented for the accumulating and disclosing of financial information in the financial statements by appropriate personnel. Responsibility is assigned to specific individuals.
  - Policies and procedures are documented for the preparation of financial statements by authorized personnel having sufficient experience and expertise to comply with U.S. GAAP.
  - Policies and procedures are documented (such as policy and procedures manuals, together with organization charts) for properly classifying and clearly describing financial information in the financial statements.
  - Reports are periodically compared with underlying documents and evaluated by supervisory personnel. Procedures are implemented to detect and correct misstatements and to evaluate recorded balances.
  - A written chart of accounts containing a description of each account is used, such as the SGL. Journal entries are prepared, reviewed, compared with supporting details where necessary, and approved each accounting period, including year-end closing.
  - Appropriate processing procedures are used, including control totals, batch totals, edit checks, or other computerized controls. Written cutoff and closing schedules are also used.
  - The same chart of accounts is used for both budgeting and reporting, and variances between actual and planned results are analyzed.



## **395 D – Selected Statutes Relevant to Budget Execution**

- .01 **Antideficiency Act:** This statute places limitations on the obligation and expenditure of government funds. Expenditures and obligations may not exceed the amounts available in the related appropriation or fund accounts. Unless expressly allowed by law, amounts may not be obligated before they are appropriated. Additionally, the amount of obligations and expenditures may not exceed the amount of the apportionments received. (See 31 U.S.C. sections 1341-1342, 1351, and 1517 for further information.) Also, see FAM 803.
- .02 **Purpose statute:** This statute states that appropriations may be obligated and expended only for the purposes stated in the appropriation. (See 31 U.S.C. 1301 for further information.)
- .03 **Time statute:** This statute states that appropriations may be obligated or expended only during the period of availability specified by law. (See 31 U.S.C. 1502 for further information.)

One-year (annual) or multiple-year (multiyear) appropriations often are referred to as **fixed accounts**. These accounts are available for obligation for a definite period of time. Multiple-year appropriations may also cover periods different than the fiscal year, such as July 1 of one fiscal year through September 30 of the next fiscal year—a period of 15 months. This type of multiple-year authority is sometimes referred to as **forward funding**.

**No-year** authority or accounts are budgetary resources that are available for obligation for an indefinite period of time, usually until the purposes for which they were provided are carried out. A no-year appropriation is usually identified by words of futurity such as “to remain available until expended.”

- .04 **Appropriation acts:** The entity’s appropriations may contain other budgetary restrictions on the appropriations provided.

## 395 E – Budget Execution Process

.01 The steps of a simplified budget process are illustrated in the following table.

| General phases | Events                       | Accounting recognition |
|----------------|------------------------------|------------------------|
| Formulation    | Budget submission            | None                   |
| Approval       | Granting budget authority    | Appropriations         |
| Execution<br>↓ | Delegation of authority<br>↓ | Apportionment          |
|                |                              | Allotment              |
|                | Use of authority<br>↓        | Commitment             |
|                |                              | Obligation             |
|                |                              | Expended authority     |
|                |                              | Outlay                 |
|                |                              | Expiration             |
|                |                              | Cancellation           |

.02 The design of the budget execution process is of interest to the auditor when testing the statement of budgetary resources and reconciliation of net cost of operations to budget note disclosure and when evaluating an entity's internal control relating to budget execution.<sup>1</sup>

- Congress provides an entity with an **appropriation (or other budget authority)**, which is authority provided by law to enter into obligations that result in immediate or future outlays (2 U.S.C. 622(2)).

<sup>1</sup>For additional information on budget execution, see OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget*, part 4. Another useful document is GAO's *A Glossary of Terms Used in the Federal Budget Process* (GAO-05-734SP, September 2005). The SGL and related accounting in the TFM can be found at <http://www.fms.treas.gov/index1.html>.

The Secretary of the Treasury issues **warrants**, which establish the amount of moneys authorized to be withdrawn from the central accounts maintained by Treasury.

- OMB makes an **apportionment**, which is a distribution of amounts available for obligation. Apportionments divide amounts available for obligation by specific periods (usually quarters), activities, projects, objects, or a combination thereof. The amounts apportioned limit the amount of obligations that may be incurred.
- The entity head (or other authorized employee) makes an **allotment**, which is an authorization to subordinates to incur obligations within a specified amount. The total amount allotted by an entity may not exceed the amount apportioned by OMB. The entity, through its fund control regulations, establishes allotments at a legally binding level for complying with the Antideficiency Act. Suballotments and allowances are further administrative divisions of funds, usually at a more detailed level (i.e., suballotments are divisions of allotments established as needed).
- The entity may make a **commitment**, which is an administrative reservation of an allotment or of other funds in anticipation of their obligation. Commitments are not required by law or regulation nor are they formal/official uses of budget authority. Rather, entities use commitments for financial planning in the acquisition of goods and services and control over obligations and the use of budget authority.
- The entity incurs an **obligation**,<sup>2</sup> which is the amount of purchase orders placed, contracts awarded, services received, and similar transactions during a given period that will require payments during the same or future periods. The entity should comply with legal requirements before recording obligations against appropriation accounts (title 7 of the *GAO Policies and Procedures Manual*). These legal requirements include determining whether the purpose, the amount, and the timing of when the obligation was incurred are in accordance with the appropriation. Additionally, there are legal requirements concerning the documentary evidence necessary for recording an obligation. The term **obligation** in this manual refers to orders for goods and services that have not been delivered (undelivered orders).

The reconciliation of net cost of operations to budget note disclosure reconciles the budgetary resources obligated for a federal entity's programs and operations, which are shown on the statement of budgetary resources and determined using budgetary accounting with the net cost of operations shown on the statement of net cost, which is determined using proprietary accounting.

- The entity records **expended authority**, which is the reduction of an obligation by the receipt and acceptance of goods and services ordered. Expended authority means that the budget authority has been used to

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<sup>2</sup>A definite commitment that creates a legal liability of the government for the payment of goods and services ordered or received, or a legal duty on the part of the U.S. that could mature into a legal liability by virtue of actions on the part of the other party beyond the control of the U.S. (GAO-05-734SP, September 2005)

acquire goods or services.<sup>3</sup>

- The entity records an **outlay**, which, as used in the President’s budget, congressional budget documents, and the statement of budgetary resources, refers to payments (cash disbursements) made to liquidate obligations for goods and services. The statement of budgetary resources reconciles obligations incurred net of offsetting collections to net outlays.
- The appropriation account **expires** when, according to the restrictions contained in the appropriation, the appropriation is no longer available for new obligations. For annual appropriations, this occurs at midnight on September 30.<sup>4</sup> Adjustments may be made for valid obligations that were either (1) recorded at an estimated amount that differs from the actual amount<sup>5</sup> or (2) incurred before the authority expired but not recorded. Adjustments may be recorded for 5 years after the appropriation expires. For both expired accounts and closed accounts, the entity’s obligations and expenditures may not exceed the related budget authority. See OMB Circular No. A-11, part 4, for additional guidance on these types of adjustments and transactions.

Examples of valid adjustments to expired accounts within the 5-year period include adjustments for

- canceled orders or orders for which delivery is no longer likely,
  - refunds received in the current period that relate to recovery of erroneous payments or accounting errors,
  - legal and valid obligations that were previously unrecorded, and
  - differences between the estimated and actual obligation amounts.
- After the 5-year period, the budget authority for the expired accounts is **canceled** and the expired accounts are **closed**.<sup>6</sup> No further adjustments or outlays may be made in those closed accounts. Payments for any outstanding unliquidated obligations in closed accounts may be made from unexpired appropriations that have the same general purpose (but are limited in aggregate to 1 percent of the current-year appropriation). For both expired

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<sup>3</sup>In the normal flow of business, when obligations are incurred, a credit to “undelivered orders” or “unexpended obligations - unpaid” is recorded (SGL account 4801) with a debit to commitments (SGL account 4700 or 4720). When the goods or services are received, the obligation is debited (SGL account 4801) with a credit to “delivered orders-unpaid” or “expended authority - unpaid” (SGL account 4901). At this time, a proprietary accounting entry is also made to debit expenditures (usually an SGL account 6100) with a credit to accounts payable (SGL account 2110). When the obligation is paid and the outlay is made, the transaction is credited to “delivered orders - paid” or “expended authority - paid” (SGL account 4902). At this time, a proprietary accounting entry is also made to debit accounts payable (SGL account 2110) with a credit to FBWT (SGL account 1010). For additional transaction details, see TFM’s U.S. Standard General Ledger Accounting Transactions supplement.

<sup>4</sup>Unobligated amounts are debited and moved to “allotments – expired authority” with a credit to SGL account 4650.

<sup>5</sup>Amounts of commitments, obligations, and expended authority may differ for a particular item acquired. Commitments are made at “initial” estimates, obligations at “later” estimates, and expended authority at “actual” amounts.

<sup>6</sup>Expired authority (SGL account 4650) is debited and moved to “canceled authority” by a credit to SGL account 4350. At this time, a proprietary entry is made to debit and reduce “unexpended appropriations” (SGL account 3106) and to credit and reduce FBWT (SGL account 1010).

accounts and closed accounts, the entity's obligations and expenditures may not exceed the related budget authority. See OMB Circular No. A-11, part 4, for additional guidance on these types of adjustments and transactions.

## **395 F – Budget Control Objectives**

.01 This section lists budget control objectives by steps in the budget process. The auditor may use these control objectives for either or both of the audit of the statement of budgetary resources and the reconciliation of net cost of operations to budget note disclosure, the evaluation of financial reporting controls; and/or as part of the evaluation of the design of compliance controls. The auditor may evaluate the design of many of these controls at the same time as evaluating the design of controls over expenses, disbursements, and liabilities. When testing control effectiveness, the auditor may test these controls at the same time, which is referred to as multipurpose testing.

- a. **Appropriations (or other forms of budget authority):** The recorded appropriation (or other form of budget authority) is the same as that made available in the appropriation or other appropriate statutes, including restrictions on amount, purpose, and timing.
- b. **Apportionments:** The recorded apportionments agree with the OMB apportionments (as indicated on the apportionment schedules), and the total amount apportioned does not exceed the total amount appropriated.<sup>1</sup>
- c. **Allotments/suballotments:** The total amount allotted does not exceed the total amount apportioned.
- d. **Commitments:** The auditor may not be concerned with controls over budgetary commitments because commitments are not required by law or regulation nor are they formal/official uses of budget authority. Controls over budgetary commitments are a type of operations control.

The auditor generally should evaluate the design of controls over commitments if the entity relies on controls over commitments to achieve the control objectives relating to obligations. If the auditor evaluates the design of controls over commitments, the auditor generally should use the same control objectives as used for obligations and expenditures, as discussed below. The auditor should test the operation of those controls that are designed and implemented effectively.

- e. **Obligation transactions:** The control objectives relating to obligation transactions (undelivered orders) are as follows:
  - **Validity/occurrence:** Obligations recorded are valid. An obligation is valid only if it meets these criteria:
    - The obligation has been incurred. This is usually evidenced by appropriate supporting documentation, such as a purchase order or contract.
    - The auditor may look for instances of “block obligating” or “block dumping,” which occur when an entity records obligations to “reserve”

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<sup>1</sup>OMB apportionments may, as a result of impoundments (rescissions or deferrals), be less than the amount of the apportionments requested by the entity. The auditor generally should notify OGC of any impoundments that come to the auditor’s attention. OMB may also approve different amounts available than those requested by time period, activity, project, or object class.

funds even though the goods or services have not been ordered. This is most likely to occur near the expiration of an appropriation and usually occurs in large dollar services and equipment contracts. The auditor may look for such signs as large, even-amount obligations near the end of the fiscal year for annual appropriations or during the last year of a multiyear appropriation account.

- The purpose of the obligation is one for which the appropriation was made.
  - The obligation was incurred within the time that the appropriation was made available for new obligations.
  - The obligation did not exceed the amount allotted or appropriated by statute nor was it incurred before the appropriation became law, unless otherwise provided by law.
  - The obligation complies with any other legally binding restrictions, such as obligation ceilings or earmarks, identified in the planning phase.
  - The obligation has not subsequently been canceled nor have the goods or services been received.
  - For adjustments to obligations in expired accounts, objectives are as follows:
    - i. If the adjustment represents a “contract change,” as defined in OMB Circular No. A-11, refer to the entity’s reporting and approval requirements in that circular.
    - ii. The adjustment does not cause the entity to exceed the amount allotted or appropriated by statute.
    - iii. The adjustment is recorded during the period when the account is available for adjustments (5 years) and was made for a valid obligation incurred before the authority expired.
    - iv. New obligations are not to be recorded in expired accounts.
  - **Completeness:** All obligation transactions are recorded.
  - **Valuation/accuracy:** Obligations are recorded at the best available estimate of actual cost.
  - **Cutoff:** Obligations are recorded in the proper period.
  - **Classification:** Obligations are recorded in the proper appropriation or fund accounts (also by program and by object, if applicable), including the proper appropriation year if the account is multiyear. Examples of programmatic account classifications are: school lunch program and nutrition education and training. Examples of object account classifications are: salaries, rent, and travel.
- f. **Expended authority transactions:** Control objectives relating to expended authority transactions, as defined in FAM 395 E, are generally the same as those for obligation transactions.

- **Validity/occurrence:** For all expended authority transactions, recorded expended authority transactions have occurred. This occurrence is usually evidenced by appropriate supporting documentation, such as invoices and receiving reports. Accrual of liabilities based on incurred but unbilled contractor costs alone is not sufficient evidence of validity (i.e., it may not meet the purpose, time, and amount provisions of an appropriation). For expended authority transactions (or adjustments to expended authority transactions) in expired accounts, the entity objectives are that
    - the expended authority transaction does not cause the entity to exceed the amount appropriated by statute,
    - the expended authority transaction is recorded during the period when the account is available for adjustments (5 years), and
    - the expenditure is not made out of a closed account.
  - **Completeness:** All expended authority transactions and adjustments are recorded.
  - **Valuation/accuracy:** Expended authority transactions and adjustments are recorded at the correct amount.
  - **Cutoff:** Expended authority transactions and adjustments are recorded in the proper period.
  - **Classification:** Expended authority transactions and adjustments are recorded in the proper appropriation or fund accounts (also by program and by object, if applicable), including the proper appropriation year if the account is multiyear.
- g. **Outlay transactions:** Control objectives that relate to outlay transactions and may be tested while auditing cash disbursements are as follows:
- **Validity/occurrence:** Outlays are supported by evidence such as contractor invoices, receiving reports, and intra-governmental payment and collection (IPAC) reports. The outlay is recorded against an obligation made during the period of availability of the appropriation (not made out of a closed account). The outlay is also for a purpose for which the appropriation was provided and in an amount not exceeding the obligation, as adjusted, authorizing the outlay. Use of “first-in, first-out” or other arbitrary means to liquidate obligations based on outlays is not generally acceptable unless supporting evidence demonstrates that in fact these estimating techniques reasonably represent the manner in which costs are incurred. (Note: Internal control over outlays and related liquidation of obligations may provide safeguards against improper payments, such as erroneous, duplicative, or fraudulent contractor billings.)
  - **Completeness:** All outlays and adjustments are recorded.
  - **Valuation/accuracy:** Outlays and adjustments are recorded at the correct amounts.
  - **Classification:** Outlays are recorded in the proper accounts (both by program and by object, if applicable), including the proper appropriation



year if the account is multiyear. This is evidenced by “matching” the outlay to the underlying obligation.

- **Cutoff:** Outlays and adjustments are recorded in the proper period.

h. **Obligation and expended authority balances:** Control objectives relating to obligation and expended authority balances as of a point in time are as follows:

- **Summarization:** Recorded balances of obligation and expended authority accounts as of a given date are supported by appropriate detailed records that are accurately summarized and reconciled to the appropriation or fund account balance, by year, for each account.
- **Substantiation:** Recorded account balances are supported by valid obligations and expended authority transactions.
- **Compliance:** Total undelivered orders plus total expended authority transactions do not exceed the amount of the appropriation or other statutory limitations (such as obligation ceilings or earmarks) that may exist by appropriation period. These other statutory limitations may limit the amount of obligations that can be incurred by program or object classification.

In addition, total payments of outstanding unliquidated obligations that relate to closed accounts do not exceed the limits described in OMB Circular No. A-11 (for annual accounts, 1 percent of the account’s current year appropriation; for multiyear accounts, 1 percent of all appropriations that are available for obligation for the same purpose, which is a single, cumulative limit).

i. **Appropriation account balances:** The control objective relating to appropriation account balances as of a point in time is as follows:

- **Cutoff/completeness/existence:** Fixed appropriation accounts are identified by fiscal year after the end of the period in which they are available for obligation until they are closed (31 U.S.C. 1553(a)).

Fixed appropriation accounts are closed on September 30 of the fifth fiscal year after the end of the period that they are available for obligation. Any remaining balance (whether obligated or unobligated) in the account is canceled and is no longer available for obligation or expenditure for any purpose (31 U.S.C. 1552(a)). For example, at the end of fiscal year 2017, the entity has accounts only for fixed appropriations that expired at the end of fiscal years 2013, 2014, 2015, 2016, and 2017. Accounts for all fixed appropriations that expired prior to these dates have been closed and their remaining balance has been canceled as of the end of fiscal year 2017.

Appropriation accounts that are available for obligation for an indefinite period are closed if (1) the entity head or the President determines that the purposes for which the appropriation was made have been carried out and (2) no disbursement has been made against the appropriation for 2 consecutive fiscal years (31 U.S.C. 1555).

- j. **Outlay account balances:** Control objectives relating to outlay account balances appearing in the statement of budgetary resources for the fiscal year are as follows:
  - **Summarization:** Recorded balances of outlay accounts for the fiscal year are supported by appropriate detailed records that are accurately summarized for each account.
  - **Substantiation:** Recorded account balances are supported by valid outlay transactions.
- k. **Recording of cash receipts related to closed appropriation accounts:** This control is to be evaluated only if these amounts are expected to exceed performance materiality. The control objective is as follows:
  - **Compliance:** Collections authorized or required to be credited to an appropriation account but not received before the account is closed are deposited in the Treasury as miscellaneous receipts (31 U.S.C. 1552(b)).

### Budget Control Objectives under the Federal Credit Reform Act

- .02 The Federal Credit Reform Act (FCRA) contains provisions regarding the recording and reporting of activity related to direct loans, loan guarantees, and modifications of these items for budget accounting purposes. Definitions of these and other FCRA terms are provided in paragraph .03 below. For transactions and account balances related to these types of activities, the auditor generally should use the budget control objectives listed in FAM 395 F and supplement them with the following budget control objectives related to FCRA. Additional guidance on FCRA accounting for budget purposes is included in OMB Circular No. A-11. Also, see Federal Financial Accounting and Auditing Technical Releases No. 3, *Auditing Estimates for Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act* (as amended), and No. 6, *Preparing Estimates for Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act*.
- a. **Obligation transactions:** Obligation transactions include direct loan obligations, loan guarantee commitments, and modifications that change the cost of an outstanding direct loan or loan guarantee (modifications do not include changes to outstanding direct loans or loan guarantees that are within the terms of existing contracts or through other existing authorities). The supplemental control objective relating to obligation transactions under FCRA is as follows:
    - **Valuation:** When funds are obligated for a direct loan or loan guarantee, the estimated cost shall be based on the “current” assumptions, adjusted to incorporate the terms of the loan contract, for the fiscal year in which the funds are obligated.<sup>2</sup>
      - 1. The cost of a direct loan is recorded at the net present value, at the time when the loan is disbursed, of estimated cash flows for

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<sup>2</sup>The term current has the same meaning as in section 250(c)(9) of the Balanced Budget and Emergency Deficit Control Act of 1985.

- a. loan disbursements;
- b. principal repayments;
- c. interest payments; and
- d. other payments by or to the government over the life of the loan, including fees, penalties, and other recoveries, as well as adjustments for estimated prepayments, delinquencies, and defaults.

These estimated cash flows include the effects of the timing and are discounted using the appropriate rate as described below.

Administrative costs and any incidental effects on governmental receipts and outlays are not included in the cost of the direct loan (2 U.S.C. 661a(5)(A) and (B)).

- 2. The cost of a loan guarantee is recorded at the net present value, at the time when the related guaranteed loan is disbursed, of the cash flows for
  - a. estimated amounts and timing of payments by the government for defaults, delinquencies, interest subsidies, or other payments, excluding administrative costs, and
  - b. estimated amounts and timing of payments to the government for origination and other fees, penalties, and recoveries.

These estimated cash flows are discounted using the appropriate rate as described below. Administrative costs and any incidental effects on governmental receipts and outlays are excluded (2 U.S.C. 661a(5)(A) and (C)).

- 3. The cost of a modification is recorded at the difference between the current estimated net present value of the remaining cash flows under the existing direct loan or guarantee contract and the estimated net present value of the remaining cash flows under the modified contract. The cash flows for each of these calculations are discounted at the rate for modifications described below (2 U.S.C. 661a(5)(D)).
- 4. The discount rate used to estimate the net present values described above is the average interest rate on marketable Treasury securities of similar maturity to the cash flows of the direct loan or loan guarantee for which the estimate is being made (2 U.S.C. 661a(5)(E)).

- b. **Expended authority transactions:** Expended authority transactions include transactions that occur when loans are disbursed. Supplemental control objectives relating to expended authority transactions under FCRA are as follows:

- **Valuation:** Expended authority transactions are recorded at the proper amount. The same specific criteria for the amounts of FCRA obligations are also applicable to expended authority transactions.
- **Cutoff:** Expended authority transactions are recorded in the proper period. Expended authority transactions for the cost of loans or guarantees are recorded in the fiscal year in which the direct or

guaranteed loan is disbursed or when a modification occurs (2 U.S.C. 661c(d)(2)).

- **Classification/presentation and disclosure:** Amounts are recorded in the proper account and reported appropriately for:
  - Differences in subsequent years between original estimated costs and reestimated costs are recorded in a separately identified subaccount in the credit program account and shown as a change in program costs and a change in net interest (2 U.S.C. 661c(f)).
  - Funding for the administrative costs of a direct loan or loan guarantee program is recorded in separately identified subaccounts within the same budget account as the program's cost (2 U.S.C. 661c(g)).
  - Cash disbursements for direct loan obligations or loan guarantee commitments made on or after October 1, 1991, are made out of the financing account (2 U.S.C. 661a(7)).
- c. **Obligation and expended authority balances:** The supplemental control objective relating to obligation and expended authority balances under FCRA as of a point in time is:
  - **Limitation:** Total obligations and total expended authority transactions do not exceed the appropriation amount or other statutory limitations that may exist by appropriation period. Specifically, see the following:
    - Direct loan obligations made on or after October 1, 1991, do not exceed the available appropriation or other budget authority.
    - Modifications made to direct loan obligations or direct loans do not exceed the available appropriation or other budget authority. (Note: Prior to performing any control or compliance tests, the auditor should discuss with OGC the applicability of this budget restriction to direct loans and direct loan obligations that were outstanding prior to October 1, 1991.)
    - Obligations for new loan guarantee commitments made on or after October 1, 1991, do not exceed the available appropriation or other budget authority.
    - Modifications made to loan guarantee commitments or outstanding loan guarantees do not exceed the available appropriation or other budget authority. (Note: Prior to performing any control or compliance tests, the auditor should discuss with OGC the applicability of this budget restriction to loan guarantees or loan guarantee commitments that existed prior to October 1, 1991.)
- d. **Cash receipts:** The control objective for cash receipts under FCRA is as follows:
  - **Classification:** Cash receipts are recorded in the proper account for:
    - Cash receipts related to direct loans obligated or loan guarantees committed prior to October 1, 1991, are recorded in the liquidating accounts (2 U.S.C. 661f(b)).

- Cash receipts related to direct loan obligated or loan guarantees committed on or after October 1, 1991, are recorded in the financing account (2 U.S.C. 661a(7)).

.03 Definitions used in FCRA are:

- **Direct loans** are disbursements of funds by the government to nonfederal borrowers under contracts that require the repayment of such funds with or without interest. Direct loans also include the purchase of, or participation in, loans made by other lenders. Direct loans do not include the acquisition of federally guaranteed loans in satisfaction of default claims or the price support loans of the Commodity Credit Corporation (2 U.S.C. 661a(1)).
- **Direct loan obligations** are binding agreements by a federal agency to make direct loans when specified conditions are fulfilled by the borrowers (2 U.S.C. 661a(2)).
- **Loan guarantees** are any guarantees, insurance, or other pledges with respect to the payment of all or a part of the principal or interest on any debt obligations of nonfederal borrowers to nonfederal lenders, but do not include the insurance of deposits, shares, or other withdrawable accounts in financial institutions (2 U.S.C. 661a(3)).
- **Loan guarantee commitments** are binding agreements by a federal agency to make loan guarantees when specified conditions are fulfilled by borrowers, lenders, or any parties to guarantee agreements (2 U.S.C. 661a(4)).
- **Cost** is defined as the estimated long-term cost to the government of a direct loan or loan guarantee, calculated on a net present value basis, or modification thereof, excluding administrative costs and any incidental effects on governmental receipts or outlays (2 U.S.C. 661a(5)). These calculations are described in further detail under the valuation control objective for obligations in FAM 395 F.
- **Credit program accounts** are the budget accounts associated with each program account into which appropriations to cover the costs of direct loans or loan guarantee programs are made and from which such costs are disbursed to the financing accounts (2 U.S.C. 661a(6)).
- **Financing accounts** are the nonbudget accounts associated with each credit program account that hold balances, receive the cost payment from the credit program account, and include all other cash flows to and from the government resulting from direct loan obligations or loan guarantee commitments made on or after October 1, 1991 (2 U.S.C. 661a(7)).
- **Liquidating accounts** are the budget accounts that include all cash flows to and from the government resulting from direct loan obligations or loan guarantee commitments made prior to October 1, 1991. These accounts are shown on a cash basis (2 U.S.C. 661a(8)).
- **Modifications** are government actions that alter the estimated cost of an outstanding direct loan (or direct loan obligation) or loan guarantee (or loan guarantee commitment) from the current estimate of cash flows (2 U.S.C. 661c(9)). These include the sale of loan assets, with or without recourse, and the purchase of guaranteed loans. They also include the actions resulting

from new statutes, or from the exercise of administrative discretion under existing law, that directly or indirectly alter the estimated cost of outstanding direct loans (or direct loan obligations) or loan guarantees (or loan guarantee commitments). For example, a policy change affecting the repayment period or interest rate for a group of existing loans would be a modification. Changes within the terms of existing contracts or through other existing authorities are not modifications under FCRA. In addition, “work outs” of individual loans, such as a change in the amount or timing of payments to be made, are not modifications. The effects of these changes are included in the annual reestimates of the estimated net present value of the obligations.

Reestimates are generally made annually to adjust the net present value of direct loans and loan guarantee obligations for changes in the estimated amounts of items such as defaults and in the timing of payments. Permanent indefinite authority has been provided for reestimates.

## **395 G – Specific Control Evaluation Worksheet**

- .01 The auditor should use the SCE worksheet or equivalent to document the evaluation of the design and implementation of the control activities in the internal control phase and the results of testing in the testing phase. This section illustrates an SCE worksheet for the **cash receipts** accounting application for a hypothetical federal government entity, “XYZ Entity” (XYZ).
- .02 The auditor should prepare an SCE worksheet or equivalent for each significant accounting application. The auditor generally should use the SCE worksheet to document the evaluation of compliance (including budget) and operations controls. The worksheet may be completed for financial reporting controls as follows:
- In column 1, list each assertion that is relevant to the accounting application. While all five financial statement assertions described in FAM 235 relate to line item/account-related accounting applications, the existence or occurrence, completeness, and accuracy/valuation assertions relate principally to transaction-related accounting applications, as illustrated in FAM 395 B. Therefore, assertions relevant to cash receipts would be existence or occurrence, completeness, and accuracy/valuation.
  - In columns 2 and 3, list the significant line items or accounts that the accounting application affects, which is obtained from the LIRA (see FAM 240). For example, cash receipts typically affect cash and accounts receivable. Document the assertions (see FAM 330) for each line item or account identified that relate to each accounting application assertion.
  - In columns 4 and 5, respectively, for each significant account assertion, identify the potential misstatements (inherent risks) that could occur in the accounting application and the related control objectives, based primarily on the list of potential misstatements and control objectives included in FAM 395 B. The auditor may tailor this list to the accounting application and the entity. In addition, the auditor may add additional objectives or subobjectives.<sup>1</sup>
  - In column 6, list control activities selected for testing that achieve each control objective identified. FAM 395 C illustrates typical control activities to achieve financial reporting control objectives.
  - In column 7, indicate whether each control activity is an IS control, a manual control, or both an IS control and a manual control. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity’s use of information systems and 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

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<sup>1</sup>On the SCE worksheet, the auditor may commingle the documentation of compliance (including budget) operations controls and safeguarding controls with that of financial reporting controls to the extent relevant, list this documentation separately in a section within the SCE worksheet, or present each of these types of controls in a separate SCE worksheet. To complete the SCE worksheet for these controls, the auditor begins by inserting relevant control objectives in column 5 and completing columns 6 through 12.

and IS controls. As noted in FAM 350.11, the auditor generally should obtain concurrence from an IS controls auditor on the auditor's identification of IS controls. IS controls consist of those internal controls that are dependent on information system processing and include general controls, application controls, and user controls. A user control can be an IS control or a manual control. User controls are considered IS controls if a dependency on information system processing exists. A user control that is an IS control is identified as both an IS control and a manual control on the SCE worksheet. Conversely, user controls are considered manual controls if no dependency on information system processing exists. A user control that is a manual control is identified as a manual control on the SCE worksheet. Manual controls are not dependent on 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. See FAM 295 F for additional information on the types of IS controls.

- In column 8, based on procedures performed in the internal control phase, conclude as to whether the control activity is designed and implemented effectively. Additionally, as noted in FAM 360.03, the auditor should also identify other IS controls (application controls and general controls implemented at the entitywide, system, and application levels) upon which the effectiveness of the IS controls included on the SCE worksheet depends. IS controls auditors will often need to assist the auditor in assessing the design and implementation of controls designated as IS controls on the SCE worksheet. As part of this assessment, the auditor assesses the design and implementation of other IS controls upon which the effectiveness of the IS controls included on the SCE worksheet depends.
- In column 9, reference the audit documentation supporting the conclusion on whether the control activity is designed and implemented effectively.
- In column 10, based on the results of the testing phase audit procedures, enter a conclusion regarding the operating effectiveness of each control activity. IS controls auditors will often need to assist the auditor in assessing the operating effectiveness of controls designated as IS controls on the SCE worksheet. As part of this assessment, the auditor assesses the operating effectiveness of other IS controls upon which the effectiveness of the IS controls included on the SCE worksheet depends.
- In column 11, conclude on whether each control objective has been achieved. This conclusion will need to consider the impact of mixed results on the effectiveness of listed individual control activities for achieving a control objective (e.g., one of the four control activities for achieving a control objective may have been ineffective, however; the combination of all control activities achieved the control objective).
- In column 12, reference the audit procedures in the detailed control testing audit plan that were designed to test each effective control determined to be relevant.

.03 The auditor should include the overall assessment of financial reporting controls by assertion in the LIRA form or equivalent document, as illustrated in FAM 395 H. If the results of testing indicate that the preliminary assessment of control effectiveness based on the design of the control was not appropriate, the



auditor should document the revised assessment in the SCE worksheet or other document, such as the audit summary memo, and the LIRA form or equivalent document.

|  |                                    |                        |                         |
|--|------------------------------------|------------------------|-------------------------|
| ENTITY: <u>XYZ Entity (XYZ)</u>              | <b>SPECIFIC CONTROL EVALUATION</b> | DESIGN PHASE SIGN-OFFS | TESTING PHASE SIGN-OFFS |
| DATE OF FIN. STMTS: <u>9/30/xx</u>           |                                    | Preparer:              | Preparer:               |
| ACCOUNTING APPLICATION: <u>Cash Receipts</u> |                                    | Primary Review:        | Primary Review:         |
| FILE: _____                                  |                                    |                        |                         |

| ACCOUNTING APPLICATION: <u>CASH RECEIPTS</u> |  |              |   |   |   |  |  |                              |                                   |                      |                                      |
|--|--|--------------|---|---|---|--|--|------------------------------|-----------------------------------|----------------------|--------------------------------------|
| ACCOUNTING APPLICATION ASSERTION             | RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS <sup>1</sup> |              | POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS                   | INTERNAL CONTROL OBJECTIVES (ICO)   | INTERNAL CONTROL ACTIVITIES (ICA)   | Type of ICA: IS, B(oth) IS and Manual, or M(anual) | INTERNAL CONTROL PHASE                           |                              | TESTING PHASE                     |                      |                                      |
|  | Cash   | Accts. Rec.  |   |   |   |  | Is the ICA Designed and Implemented Effectively? | Audit Doc. Ref. <sup>2</sup> | Is the ICA Operating Effectively? | Is the ICO Achieved? | Audit Plan Testing Step <sup>3</sup> |
| (1)  | (2)  | (3)          | (4)   | (5)   | (6)   | (7)  | (8)  | (9)                          | (10)                              | (11)                 | (12)                                 |
| Existence or occurrence                      | Existence or occurrence  | Completeness | Occurrence/validity:<br><br>1. Receipt is recorded, but cash is not received. | 1a. Recorded cash receipts and cash receipt processing procedures are authorized by federal laws, regulations, and management's policy. | 1a. Receipts processing is governed by documented procedures for accepting, obtaining, reviewing, and approving receipts. | M  | Y  |                              | Y                                 | Y                    |                                      |

<sup>1</sup> The third column is for use when the effects of the accounting application on the line items are different. For example, misstatements in the existence or occurrence assertion for cash receipts typically result in misstatements in the existence or occurrence assertion for cash and in the completeness assertion for accounts receivable (see Financial Audit Manual (FAM) 330.05).

<sup>2</sup> In this column, the auditor references the audit documentation supporting the conclusion.

<sup>3</sup> In this column, the auditor references the audit procedures in the detailed control testing audit plan (and information systems audit plan, as applicable) that were designed to test each effective control determined to be relevant. Such tests will involve inquiry, observation, inspection, or a combination thereof.

Internal Control Phase

395 G – Specific Control Evaluation Worksheet

| ACCOUNTING APPLICATION: <u>CASH RECEIPTS</u> |  |             |   |   |  |  |  |                              |                                   |                      |                                      |
|--|--|-------------|---|---|--|--|--|------------------------------|-----------------------------------|----------------------|--------------------------------------|
| ACCOUNTING APPLICATION ASSERTION             | RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS <sup>1</sup> |             | POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS | INTERNAL CONTROL OBJECTIVES (ICO)   | INTERNAL CONTROL ACTIVITIES (ICA)  | Type of ICA: IS, B(oth) IS and Manual, or M(anual) | INTERNAL CONTROL PHASE                           |                              | TESTING PHASE                     |                      |                                      |
|  | Cash   | Accts. Rec. |   |   |  |  | Is the ICA Designed and Implemented Effectively? | Audit Doc. Ref. <sup>2</sup> | Is the ICA Operating Effectively? | Is the ICO Achieved? | Audit Plan Testing Step <sup>3</sup> |
| (1)  | (2)  | (3)         | (4)   | (5)   | (6)  | (7)  | (8)  | (9)                          | (10)                              | (11)                 | (12)                                 |
|  |  |             |   | 1b. Appropriate individuals approve recorded receipts in accordance with management's general or specific criteria. | 1b. A supervisor reviews receipts processing to provide reasonable assurance that procedures are followed. | M  | Y  |                              | Y                                 | Y                    |                                      |
|  |  |             |   | 1c. Recorded receipts represent amounts actually received by the entity and are properly classified.                | 1c1. Recorded cash receipts are matched with the appropriate supporting documentation.                     | M  | Y  |                              | Y                                 | Y                    |                                      |
|  |  |             |   |   | 1c2. Entries to the accounting records are reviewed and approved by supervisory personnel.                 | M  | Y  |                              | N                                 |                      |                                      |

| ACCOUNTING APPLICATION: <u>CASH RECEIPTS</u> |  |             |   |  |   |   |  |                              |                                   |                      |                                      |
|--|--|-------------|---|--|---|---|--|------------------------------|-----------------------------------|----------------------|--------------------------------------|
| ACCOUNTING APPLICATION ASSERTION             | RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS <sup>1</sup> |             | POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS   | INTERNAL CONTROL OBJECTIVES (ICO)  | INTERNAL CONTROL ACTIVITIES (ICA)   | Type of ICA: IS, B(oth) IS and Manual, or M(annual) | INTERNAL CONTROL PHASE                           |                              | TESTING PHASE                     |                      |                                      |
|  | Cash   | Accts. Rec. |   |  |   |   | Is the ICA Designed and Implemented Effectively? | Audit Doc. Ref. <sup>2</sup> | Is the ICA Operating Effectively? | Is the ICO Achieved? | Audit Plan Testing Step <sup>3</sup> |
| (1)  | (2)  | (3)         | (4)   | (5)  | (6)   | (7)   | (8)  | (9)                          | (10)                              | (11)                 | (12)                                 |
|  |  |             | Cutoff:<br><br>2. Receipts are recorded in this period, but the cash is received in a different period. | 2. Cash receipts recorded in the period are actually received in the period. | 2. Entity personnel reconcile recorded receipts to cash receipts listings and bank deposit reports before posting.        | B   | Y  |                              | Y                                 | Y                    |                                      |
|  |  |             | Summarization:<br><br>3. Receipt transactions are overstated due to improper summarization.             | 3. The summarization of receipt transactions is not overstated.              | 3a. Entity personnel reconcile receipt data in the general ledger to subsidiary cash ledgers and records.                 | B   | Y  |                              | Y                                 | Y                    |                                      |
|  |  |             |   |  | 3b. Batch totals of input documents are automatically reconciled to output registers, journals, reports, or file updates. | B   | Y  |                              | Y                                 |                      |                                      |

| ACCOUNTING APPLICATION: <u>CASH RECEIPTS</u> |  |                         |  |   |   |  |  |                              |                                   |                      |                                      |
|--|--|-------------------------|--|---|---|--|--|------------------------------|-----------------------------------|----------------------|--------------------------------------|
| ACCOUNTING APPLICATION ASSERTION             | RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS <sup>1</sup> |                         | POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS                        | INTERNAL CONTROL OBJECTIVES (ICO)                             | INTERNAL CONTROL ACTIVITIES (ICA)   | Type of ICA: IS, B(oth) IS and Manual, or M(anual) | INTERNAL CONTROL PHASE                           |                              | TESTING PHASE                     |                      |                                      |
|  | Cash   | Accts. Rec.             |  |   |   |  | Is the ICA Designed and Implemented Effectively? | Audit Doc. Ref. <sup>2</sup> | Is the ICA Operating Effectively? | Is the ICO Achieved? | Audit Plan Testing Step <sup>3</sup> |
| (1)  | (2)  | (3)                     | (4)  | (5)   | (6)   | (7)  | (8)  | (9)                          | (10)                              | (11)                 | (12)                                 |
| Completeness                                 | Completeness   | Existence or occurrence | Transaction completeness:<br><br>4. Cash is received, but receipt is not recorded. | 4. All receipts of cash are recorded and properly classified. | 4a. Cash receipts are listed by the central mailroom staff and independently reconciled to deposits and accounting summaries, providing adequate segregation of duties. Collections and complaints are handled by others. | M  | Y  |                              | Y                                 | Y                    |                                      |
|  |  |                         |  |   | 4b. Supervisory reviews of the processing of cash receipts.   | M  | Y  |                              | Y                                 |                      |                                      |

| ACCOUNTING APPLICATION: <u>CASH RECEIPTS</u> |  |             |  |  |  |  |  |                              |                                   |                      |                                      |
|--|--|-------------|--|--|--|--|--|------------------------------|-----------------------------------|----------------------|--------------------------------------|
| ACCOUNTING APPLICATION ASSERTION             | RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS <sup>1</sup> |             | POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS  | INTERNAL CONTROL OBJECTIVES (ICO)  | INTERNAL CONTROL ACTIVITIES (ICA)      | Type of ICA: IS, B(oth) IS and Manual, or M(anual) | INTERNAL CONTROL PHASE                           |                              | TESTING PHASE                     |                      |                                      |
|  | Cash   | Accts. Rec. |  |  |  |  | Is the ICA Designed and Implemented Effectively? | Audit Doc. Ref. <sup>2</sup> | Is the ICA Operating Effectively? | Is the ICO Achieved? | Audit Plan Testing Step <sup>3</sup> |
| (1)  | (2)  | (3)         | (4)  | (5)  | (6)                                    | (7)  | (8)  | (9)                          | (10)                              | (11)                 | (12)                                 |
|  |  |             | Cutoff:<br><br>5. Cash is received in this period, but receipt is recorded in a different period.    | 5. Cash receipts actually received in the period are recorded in the period. | 5. Same as procedure 2 above.          | B  | Y  |                              | Y                                 | Y                    |                                      |
|  |  |             | Summarization:<br><br>6. Receipt transactions are understated as a result of improper summarization. | 6. The summarization of cash receipt transactions is not understated.        | 6. Same as procedures 3a and 3b above. | B  | Y  |                              | Y                                 | Y                    |                                      |

Internal Control Phase  
395 G – Specific Control Evaluation Worksheet

| ACCOUNTING APPLICATION: <u>CASH RECEIPTS</u> |  |             |   |  |  |  |  |                              |                                   |                      |                                      |
|--|--|-------------|---|--|--|--|--|------------------------------|-----------------------------------|----------------------|--------------------------------------|
| ACCOUNTING APPLICATION ASSERTION             | RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS <sup>1</sup> |             | POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS                 | INTERNAL CONTROL OBJECTIVES (ICO)                | INTERNAL CONTROL ACTIVITIES (ICA)  | Type of ICA: IS, B(oth) IS and Manual, or M(anual) | INTERNAL CONTROL PHASE                           |                              | TESTING PHASE                     |                      |                                      |
|  | Cash   | Accts. Rec. |   |  |  |  | Is the ICA Designed and Implemented Effectively? | Audit Doc. Ref. <sup>2</sup> | Is the ICA Operating Effectively? | Is the ICO Achieved? | Audit Plan Testing Step <sup>3</sup> |
| (1)  | (2)  | (3)         | (4)   | (5)  | (6)  | (7)  | (8)  | (9)                          | (10)                              | (11)                 | (12)                                 |
| Accuracy/ valuation                          | Valuation  | Valuation   | Accuracy:<br><br>7. Receipt transactions are recorded at incorrect amounts. | 7. Receipt transactions are recorded accurately. | 7a. Recorded receipts are compared with bank statements by persons who have no other receipts processing responsibilities. | M  | Y  |                              | Y                                 | Y                    |                                      |
|  |  |             |   |  | 7b. Supervisor reviews and approves reconciliations of recorded receipts to bank statements.                               | M  | Y  |                              | Y                                 |                      |                                      |

Internal Control Phase

395 G – Specific Control Evaluation Worksheet

| ACCOUNTING APPLICATION: <u>CASH RECEIPTS</u> |  |             |   |   |   |  |  |                              |                                   |                      |                                      |
|--|--|-------------|---|---|---|--|--|------------------------------|-----------------------------------|----------------------|--------------------------------------|
| ACCOUNTING APPLICATION ASSERTION             | RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS <sup>1</sup> |             | POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS | INTERNAL CONTROL OBJECTIVES (ICO)   | INTERNAL CONTROL ACTIVITIES (ICA)   | Type of ICA: IS, B(oth) IS and Manual, or M(anual) | INTERNAL CONTROL PHASE                           |                              | TESTING PHASE                     |                      |                                      |
|  | Cash   | Accts. Rec. |   |   |   |  | Is the ICA Designed and Implemented Effectively? | Audit Doc. Ref. <sup>2</sup> | Is the ICA Operating Effectively? | Is the ICO Achieved? | Audit Plan Testing Step <sup>3</sup> |
| (1)  | (2)  | (3)         | (4)   | (5)   | (6)   | (7)  | (8)  | (9)                          | (10)                              | (11)                 | (12)                                 |
|  |  |             |   | Segregation of duties: <sup>4</sup><br><br>8. Persons are prevented from having uncontrolled access to both cash receipts and records.                  | 8a. Management reviews roles and responsibilities to ensure no individual has uncontrolled access (direct or indirect) to both cash receipts and records. | M  | Y  |                              | Y                                 | Y                    |                                      |
|  |  |             |   | Laws, regulations, contracts, and grant agreements: <sup>5</sup><br><br>9. [Based on the description of the provision, document the control objective.] |   | M  | Y  |                              | Y                                 | Y                    |                                      |

<sup>4</sup> Segregation-of-duties controls are a type of safeguarding control and are often crucial to the effectiveness of controls, particularly over liquid, readily marketable assets that are highly susceptible to theft, loss, or misappropriation. If there is inadequate segregation of duties, the auditor should identify the specific affected account assertions in columns 2 and 3.

<sup>5</sup> The auditor may commingle compliance controls (including budget) with financial reporting controls to the extent relevant, list them separately in this section, or present each of these types of controls in a separate SCE worksheet (see FAM 800 for examples of compliance SCE worksheets for laws and regulations). If the auditor chooses to list the compliance controls separately in this section, the auditor begins by inserting relevant control objectives and documents the effectiveness of the design and operation of the control activities in achieving the control objectives.



## **395 H – Line Item Risk Analysis Form**

- .01 The auditor should use the LIRA form or equivalent to **summarize**, for significant line items, specific risks of material misstatement to determine the nature, extent, and timing of further audit procedures. The auditor should document any significant risks usually in the audit strategy and evaluate them when designing audit procedures but need not document them in the LIRA form. The auditor should prepare a LIRA form or equivalent for each significant line item and identify the significant accounts and related assertions.
- .02 The auditor may complete the form as the related phases of the audit are performed as follows:

### **Planning Phase:**

- In column 1, list each significant account name, and in column 2, the account balance, as discussed in FAM 235. The auditor generally groups accounts and applications together that share the same risks of material misstatement. As noted in FAM 290.08, insignificant accounts may be listed following the significant accounts. This would allow the auditor to add all account balances to the line item total and demonstrate that such balances are insignificant. In such cases, the cycle matrix is not necessary.
- In column 3, list each financial statement assertion (see FAM 260).
- In columns 4 through 6, summarize any specific inherent, fraud, or control risk factors that relate to the account and assertion from the Audit Strategy. The control risk factors include consideration of the entity-level controls (control environment, risk assessment process, monitoring, service organizations, and information and communication) (see Green Book 10.09).
- In column 7, list any mitigating factor(s) that may reduce the assessment of control risk and/or risk of material misstatement.
- In column 8, list the significant cycles and accounting applications that affect each assertion.

### **Internal Control Phase:**

- In column 9, indicate the assessment of the effectiveness of the related control activities for the assertion for each cycle and accounting application as either effective or ineffective. This assessment is obtained from the related SCE worksheet.
- In column 10, assess the control risk for each assertion as either low, moderate, or high (see FAM 370.07) and document the assessment. This assessment is based on information included in columns 5 through 7 and column 9.
- In column 11, assess the risk of material misstatement for each assertion as either low, moderate, or high (see FAM 370.09) and document the assessment. This assessment is based on the auditor's assessment of inherent risk (column 4) and control risk (column 10), along with any mitigating factors (column 7).

**Testing Phase:**

- In column 12, identify the timing of audit procedures performed as either interim (I) or final (F) (see FAM 420 and FAM 430).
  - In column 13, briefly describe the nature and extent of audit procedures performed (see FAM 420 and FAM 430).
  - In column 14, provide a reference to the audit procedure step number(s) in the testing audit plan.
- .03 If the results of testing indicate that the preliminary assessment of the risk of material misstatement was not appropriate, the auditor should document the revised assessment in the LIRA form and provide a summary of the factors contributing to the revised assessment in a memorandum, as appropriate.
- .04 The auditor may also document insignificant line items and accounts in the LIRA form rather than in the cycle matrix. Regardless, the auditor should document that **all** accounts have been considered in the audit.

Internal Control Phase  
395 H – Line Item Risk Analysis Form

ENTITY: XYZ Entity (XYZ)  
DATE OF FINANCIAL STATEMENTS: 9/30/xx  
LINE ITEM: Accounts Receivable - Net

LINE ITEM RISK ANALYSIS FORM

INDEX: \_\_\_\_\_

PREPARER \_\_\_\_\_  
REVIEWER \_\_\_\_\_  
DATE \_\_\_\_\_

| PLANNING PHASE           |               |                                |  |   |   |                                   |                               | INTERNAL CONTROL PHASE              |              |                               | TESTING PHASE |  |                                   |
|--------------------------|---------------|--------------------------------|--|---|---|-----------------------------------|-------------------------------|-------------------------------------|--------------|-------------------------------|---------------|--|-----------------------------------|
| Line Item                |               | Financial Statement Assertions | Inherent Risk Factors                            | Fraud Risk Factors                            | Control Risk Factors                            | Mitigating Factors                | Cycle/ Accounting Application | Effectiveness of Control Activities | Control Risk | Risk of Material Misstatement | Timing I/F    | Nature & Extent  | Audit Plan Testing Step           |
| Name                     | Balance       |                                |  |   |   |                                   |                               |                                     |              |                               |               |  |                                   |
| (1)                      | (2)           | (3)                            | (4)  | (5)   | (6)   | (7)                               | (8)                           | (9)                                 | (10)         | (11)                          | (12)          | (13)   | (14)                              |
| Accounts Receivable -Net | \$876,000,000 | Existence or occurrence        | No significant inherent risk factors identified. | No significant fraud risk factors identified. | No significant control risk factors identified. | No mitigating factors identified. | Sales/ billing                | Effective                           | Low          | Low                           | F             | Confirm balances and test reconciliation of subsidiary ledger to the general ledger. | AR Testing Plan – III-5 to III-7  |
|                          |               |                                |  |   |   |                                   | Sales returns                 | Effective                           |              |                               |               |  |                                   |
|                          |               |                                |  |   |   |                                   | Cash receipts                 | Effective                           |              |                               |               |  |                                   |
|                          |               |                                |  |   |   |                                   | Accounts receivable           | Effective                           |              |                               |               |  |                                   |
|                          |               | Completeness                   | No significant inherent risk factors identified. | No significant fraud risk factors identified. | No significant control risk factors identified. | No mitigating factors identified. | Sales/ billing                | Effective                           | Low          | Low                           | F             | Perform analytical procedures. Test cutoff.  | AR Testing Plan – III-8 to III-12 |
|                          |               |                                |  |   |   |                                   | Sales returns                 | Effective                           |              |                               |               |  |                                   |
|                          |               |                                |  |   |   |                                   | Cash receipts                 | Effective                           |              |                               |               |  |                                   |

Internal Control Phase  
395 H – Line Item Risk Analysis Form

| PLANNING PHASE |         |                                |                       |                    |                      |                    | INTERNAL CONTROL PHASE        |  |   | TESTING PHASE                                   |            |                 |                         |
|----------------|---------|--------------------------------|-----------------------|--------------------|----------------------|--------------------|-------------------------------|--|---|---|------------|-----------------|-------------------------|
| Line Item      |         | Financial Statement Assertions | Inherent Risk Factors | Fraud Risk Factors | Control Risk Factors | Mitigating Factors | Cycle/ Accounting Application | Effectiveness of Control Activities  | Control Risk                                  | Risk of Material Misstatement                   | Timing I/F | Nature & Extent | Audit Plan Testing Step |
| Name           | Balance |                                |                       |                    |                      |                    | Accounts receivable           | Effective  |   |   |            |                 |                         |
|                |         |                                |                       |                    |                      |                    | Accuracy/ valuation           | The bankruptcy filing by a major debtor and the financial difficulties of several other debtors in the current economic environment give rise to an inherent risk. | No significant fraud risk factors identified. | No significant control risk factors identified. |            |                 |                         |
|                |         | Sales return                   | Effective             |                    |                      |                    |                               |  |   |   |            |                 |                         |
|                |         | Cash receipts                  | Effective             |                    |                      |                    |                               |  |   |   |            |                 |                         |
|                |         | Accounts receivable            | Effective             |                    |                      |                    |                               |  |   |   |            |                 |                         |

Internal Control Phase  
395 H – Line Item Risk Analysis Form

| PLANNING PHASE  |               |                                |  |   |   |                                   |                               | INTERNAL CONTROL PHASE              |              |                               | TESTING PHASE |  |   |
|-----------------|---------------|--------------------------------|--|---|---|-----------------------------------|-------------------------------|-------------------------------------|--------------|-------------------------------|---------------|--|---|
| Line Item       |               | Financial Statement Assertions | Inherent Risk Factors                            | Fraud Risk Factors                            | Control Risk Factors                            | Mitigating Factors                | Cycle/ Accounting Application | Effectiveness of Control Activities | Control Risk | Risk of Material Misstatement | Timing I/F    | Nature & Extent  | Audit Plan Testing Step                   |
| Name            | Balance       |                                |  |   |   |                                   |                               |                                     |              |                               |               |  |   |
|                 |               | Rights and obligations         | No significant inherent risk factors identified. | No significant fraud risk factors identified. | No significant control risk factors identified. | No mitigating factors identified. | Accounts receivable           | Effective                           | Low          | Low                           | F             | Identify accounts receivable from related parties or major debtors. Review confirmations for indication of guarantees or encumbrances.                                   | AR Testing Plan – III-19 to III-22        |
|                 |               | Presentation and disclosure    | No significant inherent risk factors identified. | No significant fraud risk factors identified. | No significant control risk factors identified. | No mitigating factors identified. | Accounts receivable           | Effective                           | Low          | Low                           | F             | Determine appropriateness of footnote disclosures using FAM 2010 and FAM 2020 checklists. Summarize and test credit risk disclosures. Review accounting principles used. | AR Testing Plan – III-23 to III-25, IV-16 |
| Line Item Total | \$876,000,000 |                                |  |   |   |                                   |                               |                                     |              |                               |               |  |   |

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# SECTION 400

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Testing Phase

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## **410 – Overview of the Testing Phase**

- .01 Audit evidence is all the information that auditors use to reach conclusions contained in auditor's reports and includes the information in the accounting records underlying the financial statements and other information (see AU-C 500). During the testing phase of the audit, the auditor gathers sufficient appropriate audit evidence to report on the entity's financial statements; internal control; whether the entity's financial management systems are in substantial compliance with the three requirements of Federal Financial Management Improvement Act of 1996 (FFMIA) (for Chief Financial Officers (CFO) Act agencies); and the entity's compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.

When using information produced by the entity, the auditor should evaluate whether the information is sufficiently reliable for the auditor's purposes, including, as necessary, in the following circumstances (a) obtaining audit evidence about the accuracy and completeness of the information and (b) evaluating whether the information is sufficiently precise and detailed for the auditor's purposes (AU-C 500.09).

- .02 Audit sampling is often used in audit testing. The auditor uses professional judgment,<sup>1</sup> as well as knowledge of statistical sampling methods, in applying audit sampling. When designing an audit sample, the auditor should consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn (AU-C 530.06). FAM 400 provides a framework for applying audit sampling to financial audits, but is not a comprehensive discussion. Additional background and guidance on audit sampling is provided in the AICPA audit guide, *Audit Sampling*.

The auditor should consult with an audit sampling specialist for assistance in designing and evaluating audit samples and in evaluating the costs and benefits when deciding the appropriate type of audit sampling to use, unless the auditor determines only basic statistical concepts are applied

- .03 During this phase, the auditor performs activities for each type of test to
- determine the nature, extent, and timing of further audit procedures (FAM 420);
  - design tests (FAM 430); and
  - perform tests and evaluate results (FAM 440).
- .04 The types of procedures performed in the testing phase are as follows:
- **Sampling control tests** that may be performed by the auditor to obtain evidence about achieving specific control objectives. If the auditor obtains sufficient evidence regarding control objectives through nonsampling control tests (such as inquiry in combination with observation or inspection of documents which can be performed as a part of walk-throughs), sampling

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<sup>1</sup>All decisions should be documented and supported.



control tests are not necessary, as discussed in FAM 350. Further guidance on sampling control tests is in FAM 450.

- **Compliance tests** are performed by the auditor to obtain evidence about compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements. Further guidance on compliance tests is in FAM 460.
- **Substantive procedures** are performed by the auditor to obtain evidence that provides reasonable assurance about whether the financial statements and related assertions are free of material misstatement. Further guidance on substantive procedures is in FAM 470, FAM 475, and FAM 480.

.05 Audit documentation of the nature, extent, and timing of procedures performed during this test phase, as well as conclusions reached, is discussed in FAM 490.

## **420 – Design the Nature, Extent, and Timing of Further Audit Procedures**

### **Design Further Audit Procedures**

- .01 As discussed in FAM 200 (Planning Phase) and FAM 300 (Internal Control Phase), the auditor performs risk assessments in planning procedures for obtaining audit evidence about control effectiveness and about assertions in account balances and classes of transactions. Audit evidence is all the information that auditors use to reach conclusion contained in auditor's reports. Obtaining evidence is a cumulative process.
- .02 If information to be used as audit evidence has been prepared using the work of a management's specialist (those with expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data), see FAM 625.
- .03 The auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level (AU-C 330.05). In designing substantive tests, the auditor should design audit procedures whose nature, extent, and timing are based on and are responsive to the assessed risk of material misstatement at the relevant assertion level, and should (AU-C 240.30 and 330.06) do the following:
  - Consider the reasons for the assessed risk of material misstatement at the relevant assertion level for each class of transactions, account balance, and disclosure, including (a) the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (the inherent risk) and (b) whether the risk assessment takes account of relevant controls (the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures).
  - Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (AU-C 330.07)

The design of specific audit procedures is further discussed in FAM 430; sampling control tests in FAM 450; compliance tests in FAM 460; FFMIA tests in FAM 701 and 701 A; and substantive procedures in FAM 470, FAM 475, and FAM 480.

### **Determine the Nature of Tests**

- .04 Further audit procedures consist of tests of controls and substantive procedures. The auditor should determine the nature of sampling control tests, compliance tests, and substantive procedures that will achieve the audit objectives.
- .05 Substantive procedures are classified as either substantive analytical procedures or detail tests. Substantive analytical procedures involve comparing the recorded test amount with the auditor's expectation of the recorded amount and

investigating any significant differences between these amounts. Further information on substantive analytical procedures is in FAM 475.

Detail tests are classified in two general categories: audit sampling and nonsampling. Audit sampling methods involve selecting individual items from a population with the objective of reaching a conclusion on all the items in the population. Nonsampling methods involve selecting items to reach a conclusion only on the items tested. When using nonsampling, the auditor should assess the risk of material misstatement in the items not tested.

- .06 When designing and performing audit procedures, the auditor should consider the relevance and reliability of the information to be used as audit evidence (AU-C 500.07). The higher the auditor's assessment of risk of material misstatement, the more reliable and relevant the audit evidence from substantive procedures needs to be. The auditor should determine the nature of the population and the objectives of the test procedures. For tests that involve audit sampling, efficiencies can be achieved by using a common sample (multipurpose testing) for each test. These potential efficiencies are discussed in FAM 430. It should be noted that multipurpose tests may not be efficient if conducted during the first 2 years of a new audit. This is based on the fact that the auditor may not be as aware of the operating effectiveness of the controls in place at an entity in a new audit and the rate of deviation may be higher than expected.

## **Determine the Extent of Tests**

- .07 For each type of test, the auditor should determine the extent of tests to be performed. The extent of sampling control tests is a function of the auditor's preliminary assessment of the risk of material misstatement, tolerable rate of deviation,<sup>1</sup> and the rate of control deviations expected.<sup>2</sup> The extent of compliance tests is a function of the effectiveness of compliance controls. The extent of substantive procedures is a function of the risk of material misstatement, expected misstatement, and tolerable misstatement.

## **Determine the Timing of Tests**

- .08 If substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing (a) substantive procedures, combined with tests of controls for the intervening period, or (b) if the auditor determines that it is sufficient, further substantive procedures only, that provide a reasonable basis for extending the audit conclusions from the interim date to the period-end (AU-C 330.23). As discussed in FAM 295 D, the auditor may conduct tests before the date of the financial statements (interim testing) or conduct all tests as of the date of the financial statements. FAM 495 C provides guidance on interim testing, tests of the period between the interim date and the date of the financial statements (the roll-forward period), and related documentation.

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<sup>1</sup>Tolerable rate of deviation (also referred to as tolerable error, tolerable rate, or tolerable deviation) is the maximum rate of deviations from the prescribed control that the auditor is willing to accept without altering the preliminary control risk.

<sup>2</sup>The rate of control deviations expected is an anticipation of the deviation rate in the entire population.

## **430 – Design Tests**

- .01 After considering the risk of material misstatement discussed in FAM 420, the auditor should design specific tests to be performed. To realize efficiencies in tests that involve audit sampling, the auditor can perform several tests on a common sample (multipurpose testing).<sup>1</sup> The auditor generally should minimize the number of separate sampling applications performed on the same population by attempting to effectively achieve as many objectives as possible using the items selected for testing.
- .02 When designing tests of controls and tests of details, the auditor should determine the means of selecting items for testing that are effective in meeting the purpose of the audit procedure (AU-C 330.25). As discussed in FAM 480, there are several methods of selecting items for testing. When determining the selection method to use during a multipurpose test, the auditor generally should use the selection method appropriate for substantive detail tests in the particular situation. This selection method is usually the most efficient because generally sampling control and compliance tests may be based on any type of sample.
- .03 For example, the auditor may use a sample of property additions to (1) substantively test the amount of additions and (2) test financial reporting controls over property acquisition. If a substantive test would require 135 sample items selected using monetary unit sampling (MUS) and if the test of financial reporting controls would require 45 sample items, the auditor may either test controls relating to all 135 sample items or select a separate sample of 45 sample items from the general population for control testing.

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<sup>1</sup>In addition to number of sampling applications, many factors influence efficiency, such as sample size, number of locations it is necessary to visit to achieve audit objectives, nature of the audit procedures, extent of review required, and whether rework can be avoided by designing easy-to-follow procedures.

## **440 – Perform Tests and Evaluate Results**

- .01 The auditor should perform the planned tests as designed in FAM 420 and FAM 430 and should evaluate the results of each type of test separately, without respect to whether the items were chosen as part of a multipurpose test. Guidance on performing and evaluating the results is presented for each type of test in the following sections:
- FAM 450 – Sampling Control Tests
  - FAM 460 – Compliance Tests
  - FAM 470 – Substantive Procedures
- .02 The auditor should evaluate (a) the results of the sample, including sampling risk, and (b) whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested (AU-C 530.14)
- If the results of tests are different from what was expected during design of the tests, the auditor may want to expand the sample to test additional items; however, this is usually not appropriate. In a well-designed sample, the expanded sample will not usually materially change the sample results. For MUS and attribute samples, unless the auditor plans for the expansion of the sample in advance,<sup>1</sup> expansion of the sample is generally not appropriate. See the AICPA's audit guide, *Audit Sampling* for further guidance. The auditor should consult with the audit sampling specialist before expanding any samples (see FAM 450.22, FAM 460.02, and FAM 480.28).
- .03 The auditor should evaluate the effect of the findings of the substantive procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This should include, at a minimum, the following:
- The risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
  - Findings with respect to illegal acts and related party transactions.
  - Indications of management bias in making accounting estimates and in selecting accounting principles.
  - Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the relevant assertion being tested are effective (AU-C 330.16).
- .04 [INTENTIONALLY LEFT BLANK]

### **Evaluate the Risk of Material Misstatement**

- .05 Evaluating the risk of material misstatement due to errors or fraud is a cumulative, ongoing process throughout the audit (as discussed in FAM 260).

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<sup>1</sup>Usually, this is covered by selecting a larger sample than needed. If the auditor believes a larger sample is necessary, the auditor should consult with an audit sampling specialist.

During testing, the auditor may become aware of additional fraud risk factors or other conditions that may affect the auditor's evaluation of the risk of material misstatement, such as

- discrepancies in the accounting records,
- conflicting or missing evidential matter, or
- problematic or unusual relationships between management and the entity being audited.

In response to fraud risk factors or other conditions, the auditor should evaluate whether to perform additional or different audit procedures (see FAM 540.18 through .21), including consultation with the Special Investigator Unit and Office of the General Counsel (OGC).

## **450 – Perform Sampling Control Tests**

- .01 The auditor should design and perform tests of control effectiveness at the relevant assertion level when the auditor's preliminary assessment of the risk of material misstatement includes an expectation of the operating effectiveness of controls, or when substantive procedures alone do not provide sufficient appropriate audit evidence (AU-C 330.08). In designing and performing tests of controls, the auditor should obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control (AU-C 330.09). For entities subject to OMB audit guidance, for controls that have been suitably designed and implemented, the auditor should perform sufficient tests to support a low level of assessed control risk.
- .02 The auditor may test controls that provide documentary evidence of their existence and application by inspecting this evidence. If the auditor cannot obtain sufficient evidence using walk-throughs in combination with other observation and inquiry tests, the auditor may obtain more evidence by inspecting individual items selected using audit sampling procedures.
- The auditor may use multipurpose testing by using the same sample to test controls and/or compliance and/or balances (test of details) for efficiency. Alternatively, the auditor may design a sample to test controls alone. In this case, the auditor should use attribute sampling, selected either randomly or systematically where appropriate, as described beginning in FAM 450.06.
- .03 When planning sampling control tests, the auditor should determine a sample size sufficient to reduce sampling risk to an acceptably low level (AU-C 530.07). The auditor should determine
- the objectives of the test (including what constitutes a deviation),
  - the population (including sampling unit and time frame),
  - the method of selecting the sample, and
  - the sample design and resulting sample size.
- The auditor should include the sampling plan in audit documentation. See FAM 495 E for sampling flowcharts and example documentation.

### **Document Objectives of the Tests**

- .04 The auditor should document the objectives of each control test. In designing samples for control tests, the auditor should plan to evaluate operating effectiveness in terms of the rate of deviations in units or dollars from prescribed controls. This involves defining (1) the specific control to be tested and (2) what constitutes an error, exception, or control failure. The auditor should define control deviations in terms of control activities not followed. For example, the auditor may define a deviation in cash disbursements as "invoice not approved and initialed by an authorized individual."
- For financial reporting control tests, the objective is to support the preliminary assessment of control risk as either moderate or low. For compliance and operations control tests, the objective is to support the preliminary assessment of the control as effective. In addition, for financial reporting and compliance control

tests, the objective is obtaining evidence to support the auditor's report on internal control.

## Define the Population

- .05 In defining the population, the auditor should identify the whole set of items on which the auditor needs to reach a conclusion and from which the sample will be drawn. This includes
- describing the population;
  - conducting data reliability tests to determine whether the population is complete and valid;
  - determining the source document or the transaction documents to be tested; and
  - defining the period covered by the test.

When multiple locations are involved, the auditor should determine whether to use one population of all or several locations, or whether to use separate populations. The auditor may be able to use one population if the controls at each location are components of one overall control system. In making this decision, the auditor may evaluate such factors as

- the extent of uniformity of the controls and their applications at each location,
- whether significant changes can be made to the controls or their applications at the local level,
- the amount and nature of centralized oversight or control over local operations, and
- whether there could be a need for separate conclusions for each location.

If the auditor concludes that the locations are separate populations, the auditor should select separate samples at each location and evaluate the results of each sample separately.

## Choose Method of Selection

- .06 The auditor should select items for the sample in such a way that the auditor can reasonably expect the sample to be representative of the relevant population and likely to provide the auditor with a reasonable basis for conclusions about the population (AU-C 530.08). For tests of controls, attribute sampling achieves this objective. Attribute sampling requires random or systematic, if appropriate, selection of sample items without considering the transaction's dollar amount or other special characteristics. The auditor may also use COTS such as IDEA or other software to make random selections.

## Determine Sample Size

- .07 [INTENTIONALLY LEFT BLANK]
- .08 To determine the sample size, the auditor uses professional judgment to determine four factors (AU-C 530.A13):



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## Testing Phase

### 450 – Perform Sampling Control Tests

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- confidence level;<sup>1</sup>
- tolerable rate of deviation of the population to be tested (maximum rate of deviations from the prescribed control that the auditor is willing to accept without altering the preliminary control risk);
- expected rate of deviation of the population to be tested (expected error rate); and
- the desired level of assurance (complement of risk of overreliance) that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population—the auditor may decide the desired level of assurance based on the extent to which the auditor’s risk assessment takes into account relevant controls.

Once the auditor determines these factors, the auditor may use computer software (such as IDEA) to determine sample size and to select samples for testing. The auditor may also use Tables I and II in Figure 450.1 to determine sample size and to evaluate test results for controls that operate more frequently than weekly.<sup>2</sup>

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<sup>1</sup>The confidence level is the probability associated with the precision, that is, the probability that the true misstatement is within the confidence interval. This is not the same as assurance.

<sup>2</sup>Tables I and II assume a population over 5,000 items. If the population is smaller, the auditor may ask the audit sampling specialist to calculate a reduced sample size and to evaluate the results. The effect is generally small unless the sample size per the table is more than 10 percent of the population.

**Figure 450.1: Sample Sizes and Acceptable Numbers of Deviations**

| 90% Confidence Level   |                                    |   |                                    |
|--|------------------------------------|---|------------------------------------|
| Table I<br>Tolerable rate of deviation<br>of 5%<br>(Use for determining<br>sample sizes in<br>all cases) |                                    | Table II<br>Tolerable rate of deviation<br>of 10%<br>(Use for evaluating sample<br>results only if preliminary<br>assessment of control risk is<br>low and deviations exceed<br>those in Table I) |                                    |
| Sample<br>Size   | Acceptable number<br>of deviations | Sample<br>Size  | Acceptable number<br>of deviations |
| 45   | 0                                  | 45  | 1                                  |
| 78   | 1                                  | 78  | 4                                  |
| 105  | 2                                  | 105   | 6                                  |
| 132  | 3                                  | 132   | 8                                  |
| 158  | 4                                  | 158   | 10                                 |

The auditor may use Table I to determine the sample sizes necessary to support the preliminary assessments of controls in all cases and to conclude on the effectiveness of the controls. The auditor may use Table II to evaluate sample results only when the preliminary assessment of financial reporting control risk is low and the number of deviations found exceeds the acceptable number of deviations from Table I.

The AICPA has other examples in its guidance, and the table factors are within the range of the AICPA examples and are statistically valid. If an auditor chooses to use factors other than Tables I and II, the auditor should consult with the audit sampling specialist.

- .09 Tables I and II are based on a 90 percent confidence level. The auditor generally uses this confidence level for sampling control tests because the auditor generally obtains additional satisfaction on controls through other audit tests, such as substantive procedures, inquiry, observation, and walk-throughs.
- .10 Tables I and II are each based on different tolerable rates of deviation. Table I is based on a tolerable rate of deviation of 5 percent, and Table II is based on a tolerable rate of deviation of 10 percent. Each table shows various sample sizes and the maximum number of deviations that may be detected in each sample to rely on the controls at the determined control risk level. See FAM 450.13 through .17 for a discussion of the evaluation of test results.<sup>3</sup>
- .11 For financial reporting controls, if the preliminary assessment of control risk is low or moderate, the auditor may use Table I to determine sample size. OMB audit guidance requires the auditor to perform sufficient control tests to support a low

<sup>3</sup>Tables I and II assume a population over 5,000 items. If the population is smaller, the auditor may ask the audit sampling specialist to calculate a reduced sample size and to evaluate the results. The effect is generally small unless the sample size per the table is more than 10 percent of the population.

level of assessed control risk, if controls have been suitably designed and implemented.

For compliance and operations controls, the auditor may determine sample sizes using Table I.

- .12 The auditor may use the sample size indicated for zero acceptable deviations (45 items) if the auditor expects no deviations. If no deviations are expected, this sample size will be the most efficient for assessing control effectiveness. If no deviations are found, this sample will be sufficient to support the assessment of control risk. However, the auditor may use a larger sample size if control deviations are expected to occur but are not expected to exceed the acceptable number of deviations in Table I.

### **Evaluate Test Results (AU-C 530.14)**

- .13 If deviations from controls upon which the auditor intends to rely are detected, the auditor should make specific inquiries to understand these matters and their potential consequences and should determine whether (a) the tests of controls that have been performed provide an appropriate basis for reliance on the controls, (b) additional tests of controls are necessary, or (c) the potential risks of misstatement need to be addressed using substantive procedures (AU-C 330.17).

### **Financial Reporting Controls**

- .14 Deviations from controls may be caused by factors such as changes in key personnel, significant seasonal fluctuations in the volume of transactions, and human error. When deviations are detected during tests of controls, the auditor should investigate the nature and cause of any deviations or misstatements identified and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit (AU-C 530.12). The auditor should make specific inquiries to understand these matters and their potential consequences, for example, by inquiring about the timing of personnel changes in key internal control functions. In addition, the auditor should determine whether any misstatements detected from the performance of substantive procedures alter the auditor's judgment as to the effectiveness of related controls. The auditor should determine whether the tests of controls performed provide an appropriate basis for reliance on the controls, whether tests of other controls (such as compensating controls) are necessary, or whether the potential risks of material misstatement should be revised and whether adjustments to nature, timing, and extent of substantive procedures are necessary.
- .15 To evaluate sample results, the auditor considers the sample size, the number of deviations, and the confidence level. The auditor may use software (such as IDEA), the tables above, or other tables to evaluate results.<sup>4</sup> If the auditor used Table I to determine sample size, and deviations exceed the acceptable number

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<sup>4</sup>Using the AICPA guidance, the auditor computes the deviation rate and the upper limit at the desired confidence level (usually the same confidence level used to determine sample size). If the upper limit of deviations is less than the tolerable rate of deviation, the results support the control risk assessment. If not, the auditor should increase the assessed control risk when designing substantive procedures.

for the sample size, the auditor should follow the guidance below in deciding how to revise the preliminary assessment of control risk.

- **Low control risk:** If the **preliminary assessment of control risk** is low and if deviations are noted that exceed the acceptable number for Table I, but not Table II, the auditor may reassess control risk as moderate. For example, if the original sample was 45 items, the auditor may reassess control risk as moderate if there is not more than 1 deviation. If the auditor finds more than one deviation with a sample size of 45 items, the auditor should conclude that the controls being tested are not operating effectively and should reassess control risk as high. Based upon this revised assessment, the auditor would change the risk of material misstatement and would reconsider the nature, extent, and timing of substantive procedures.
- **Moderate control risk:** If the **preliminary assessment of control risk** is moderate and if control deviations exceed the acceptable number for Table I, the auditor should conclude that control risk is high. The preliminary assessment of control risk is based on the assumption that the controls operate as designed. If the preliminary assessment of control risk is moderate and if control tests indicate that the control is not operating as designed (because deviations exceed the acceptable number in Table I), the auditor should conclude that the control is ineffective and revise the control risk assessment to high. Based on the revised assessment, the auditor would change the risk of material misstatement and would reconsider the nature, extent, and timing of substantive procedures.

### **Compliance Controls**

- .16 If the auditor used Table I to determine sample size and deviations exceed the acceptable number for the sample sizes shown in the table, the auditor should conclude that the compliance control is not effective. The auditor also should determine whether any deviations noted ultimately resulted in noncompliance with a significant provision of an applicable budget-related or other law, regulation, contract, or grant agreement. Based on the revised assessment, the auditor would change the risk of noncompliance and would reconsider the nature, extent, and timing of tests of compliance.

### **Operations Controls**

- .17 If the auditor used Table I to determine sample size and deviations exceed the acceptable number for the sample sizes shown in the table, the auditor should conclude that the operations control is not effective.

### **Other Considerations**

- .18 The auditor should perform audit procedures, appropriate to the purpose, on each item selected (AU-C 530.09). If the designed audit procedure is not applicable to the selected sample item, the auditor should perform the procedure on a replacement item (AU-C 530.10). An example of when it is necessary to perform the procedure on a replacement item is when a voided check is selected while testing for evidence of payment authorization. If the auditor is satisfied that the check has been properly voided such that it does not constitute a deviation,

an appropriately chosen replacement is examined (AU-C 530.A18). Consult with the audit sampling specialist to select replacement items.

- .19 If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor should treat that item as a deviation from the prescribed control (in the case of tests of controls) or a misstatement (in the case of tests of details. See FAM 480) (AU-C 530.11). In some circumstances, the auditor may not be able to apply the planned audit procedures to selected sample items because, for example, the entity might not be able to locate supporting documentation. The auditor's treatment of unexamined items will depend on their effect on the auditor's evaluation of the sample. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be misstated, it may not be necessary to examine the items, for example, if the aggregate amount of the unexamined items, if treated as misstatements or deviations, would not cause the auditor's assessment of the amount of the misstatement or deviation in the population to exceed tolerable misstatement or tolerable rate of deviation, respectively. However, when this is not the case, the auditor should perform alternative procedures that provide sufficient appropriate audit evidence to form a conclusion about the sample item and use the results of these procedures in assessing the sample results. If alternative procedures cannot be satisfactorily performed in these cases, the auditor is required to treat the items as misstatements or deviations, as appropriate, in evaluating the results of the sample. AU-C 240, Consideration of Fraud in a Financial Statement Audit, also requires the auditor to consider whether the reasons for the auditor's inability to examine the items have implications with regard to assessing risks of material misstatement due to fraud, the assessed level of control risk that the auditor expects to be supported, or the degree of reliance on management representations. (AU-C 530.A19)
- .20 If, during the testing of sample items, the number of deviations exceeds the acceptable number of deviations in Table I or II (as applicable), the auditor should conclude that controls are not operating effectively and decide whether to stop further testing. In making this decision, the auditor should determine whether there are reasons for continuing to test the remaining sample items. For example, the audit team may need to determine whether additional information (such as an estimate of the population rate of occurrence) is needed to report control deficiencies as described in FAM 580.44-.72. An interval estimate may help the auditor decide whether the deficiency is a material weakness, other significant deficiency or other control deficiency.
- .21 The auditor should determine which elements of the finding (condition, cause, criteria, possible effect, and recommendation or suggestion) need to be developed. The auditor may decide to include an interval estimate in the report. The auditor should consult with audit team management and the audit sampling specialist as applicable in deciding whether to complete the testing of the sample.
- .22 If the auditor finds an unacceptable number of deviations in the original sample and the auditor believes the use of a larger sample size may result in an acceptable number of deviations, the auditor should consult with the audit sampling specialist before selecting additional sample items. The auditor should not use a revised sample size and evaluate additional sample items based on Tables I or II or on the formulas used by certain audit software such as IDEA.

- .23 The auditor should project the results of audit sampling to the population (AU-C 530.13). The auditor should consult with the audit sampling specialist when projecting the rate of sample control deviations to a population for disclosure in a report. If the auditor has used attribute sampling, the auditor should project the deviation rate as a percentage of transactions. If the auditor has used MUS (as part of multipurpose testing), the auditor should project the deviations to the population as a net upper error limit (see FAM 480).

## 460 – Perform Compliance Tests

- .01 The type of provision of a law, regulation, contract, or grant agreement and the assessment of the effectiveness of compliance controls affect the nature and extent of compliance testing. Based on the three categories of provisions (as discussed in FAM 340.06) the auditor should perform the applicable compliance tests discussed below.

The auditor should perform audit procedures, appropriate to the purpose, on each item selected (AU-C 530.09). If the designed audit procedure is not applicable to the selected sample item, the auditor should perform the procedure on a replacement item (AU-C 530.10).

### Transaction-Based Provisions

- .02 To test transaction-based provisions, the auditor should use audit sampling to select specific transactions for compliance testing. The auditor may use the same sample to test financial reporting, compliance, or operations controls and/or substantive tests, as appropriate (multipurpose testing). If the selection is solely for compliance testing, the auditor generally should use a random attribute sample (see FAM 450.06). To determine sample size, the auditor should make judgments as to confidence level, tolerable rate of deviation, and expected population deviation rate. The auditor should determine confidence level based on compliance control risk.

For example, if the auditor determines that compliance controls are effective, the auditor may use an 80 percent confidence level, or if ineffective, a 95 percent confidence level. Tolerable rate of deviation is the rate of transactions not in compliance that could exist in a population without causing the auditor to believe the noncompliance rate is too high. GAO auditors generally use a 5 percent tolerable rate of deviation. Since the auditor will assess the impact of all identified noncompliance, many auditors use zero as the expected population deviation rate. Using the above factors yields the sample sizes in Table 460.1.

**Table 460.1: Compliance Controls, Confidence Level, and Minimum Sample Size**

| Compliance controls | Confidence level (percentage) | Minimum sample size <sup>a</sup> |
|---------------------|-------------------------------|----------------------------------|
| Effective           | 80                            | 32                               |
| Not effective       | 95                            | 58                               |

<sup>a</sup>This sample has a tolerable rate of deviation of 5 percent, expected population deviation rate of zero, and a population of more than 5,000 items. If the population is smaller, the auditor may ask the audit sampling specialist to calculate a reduced sample size and evaluate the results.

Since the auditor usually reports compliance on an entity-wide basis, the auditor may use these sample sizes on an entity-wide basis. Evaluation of test results is discussed in FAM 460.07. The auditor should test the entire sample, even if instances of noncompliance are detected. If the auditor assessed compliance controls on a preliminary basis as effective and the results of testing indicated that this assessment is not appropriate, the auditor should consult with the audit

sampling specialist to determine the appropriate sample size and selection procedures. If the auditor decides to expand the original sample (instead of reselecting an entirely new sample), the auditor should select additional items needed to increase the sample size using the random number used to select the original sample. The audit sampling specialist should evaluate results when the auditor expands a test.

## Quantitative-Based Provisions

- .03 Effective compliance controls provide reasonable assurance that the accumulation/summarization of transactional information is accurate, complete, and within authorized limits. If compliance controls do not provide such reasonable assurance, the auditor should test the accumulated information directly for existence, completeness, and summarization. Such tests may be either statistical samples or nonsampling selections. The auditor should design tests to detect misstatements that exceed either an auditor-determined percentage of the total amount of the summarized information or the amount of the restriction stated in the provision, if any. GAO auditors generally use 5 percent for this tolerable misstatement. The amount of the restriction is described in FAM 245.06.

The auditor may discontinue such tests if significant misstatements in the accumulated information are noted that would preclude compliance. The test for compliance is the comparison of the accumulated or summarized information with any restrictions on the amounts stated in the identified provision.

- .04 If the auditor determines that provisions of applicable budget-related laws and regulations are significant, and if related budget and, consequently, compliance controls are ineffective, the auditor should test the accumulated or summarized information directly for the following potential misstatements in budget execution information:
- **Occurrence/validity:** Recorded amounts are not valid. (See FAM 395 F for occurrence/validity criteria for obligations, expended authority, and outlays.)
  - **Completeness:** Not all amounts that should have been recorded are recorded.
  - **Cutoff:** Obligations, expended authority, and outlays are not recorded in the proper period.
  - **Accuracy:** Obligations, expended authority, and outlays are not recorded at the proper amounts.
  - **Classification:** Obligations, expended authority, and outlays are not recorded in the proper account by program and by object, if applicable, including the proper appropriation year if the account has multiple years. (Examples of program and object classifications are provided in FAM 395 F.)
  - **Summarization:** Transactions are not properly summarized to the respective account totals.
- .05 An example of audit procedures to test for these misstatements is included in FAM 495 B.



## Procedural-Based Provisions

- .06 In testing compliance controls relating to a procedural-based provision, the auditor should obtain sufficient evidence to conclude whether the entity performed the procedure and therefore complied with the provision. An example of a procedural-based provision could be when an entity is required to obtain certain information from grantees. In this case, the auditor would obtain evidence of whether such information was received and therefore whether the entity complied with the provision. If compliance control tests do not provide sufficient evidence to determine compliance, the auditor should perform additional procedures, as necessary, to obtain such evidence.

## Evaluating Test Results

- .07 For any suspected instances of reportable noncompliance (see FAM 580.80) noted in connection with the procedures described above or other audit procedures, the auditor should do the following:
- a. Obtain (1) an understanding of the nature of the noncompliance and the circumstances in which it occurred and (2) further information to evaluate the possible effect on the financial statements (AU-C 250.17).
  - b. Investigate the nature and cause of any deviations or misstatements identified and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit (AU-C 530.12).
  - c. Discuss the matter with management (at a level above those involved with the suspected noncompliance, if possible) and, when appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws, regulations, contracts, and grant agreements, and in the auditor's professional judgment the effect of the suspected noncompliance may be material to the financial statements, the auditor should consider the need to obtain legal advice (AU-C 250.18).
  - d. If the auditor suspects that management or those charged with governance are involved in noncompliance, the auditor should communicate the matter to the next higher level of authority at the entity, if it exists. When no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure about the person to whom to report, the auditor should consider the need to obtain legal advice (AU-C 250.23).
  - e. Discuss such suspected instances of reportable noncompliance with OGC and, when appropriate, the Special Investigator Unit and conclude whether noncompliance has occurred and the implications of any noncompliance.
  - f. Identify the deficiency in compliance controls that did not prevent or detect and correct the noncompliance, if it was not previously identified during compliance control testing.
  - g. Report any material weakness and other significant deficiencies in compliance controls and determine the effect, if any, on the report (or opinion) on internal control (see FAM 580.44 through .70).
  - h. Determine the implications of any instances of reportable noncompliance on the financial statements.

- i. Determine the implications of any instances of reportable noncompliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of management's representations (AU-C 250.20).
- j. Report instances of noncompliance, as appropriate (see FAM 580.76 through .86).

## **470 – Perform Substantive Procedures – Overview**

- .01 In the internal control phase, the auditor performed a preliminary assessment of the risk of material misstatement for each significant assertion within each significant line item or account (see FAM 370). In the testing phase, the auditor plans and performs further audit procedures to respond to the risk of material misstatement.

Based on the assessed risk of material misstatement, the auditor should design and perform substantive procedures for relevant assertions related to each material class of transactions (such as payroll or nonpayroll expenditures), line items (such as Fund Balance with Treasury (FBWT)), and account balances (such as individual FBWT accounts). However, irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure (AU-C 330.18). Additionally, if the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details (AU-C 330.22).

- .02 The auditor's objective during substantive procedures is to determine whether assertions are materially misstated and to form an opinion about whether the financial statements taken as a whole are presented fairly, in all material respects, in accordance with U.S. GAAP. To determine if assertions are misstated, the auditor should design substantive procedures to detect each of the potential misstatements in assertions that were developed in the internal control phase (see FAM 330).

The auditor's substantive procedures also should include audit procedures related to the financial statement closing processes, such as

- agreeing or reconciling the financial statements with the underlying accounting records (AU-C 330.21.a) and
- examining material journal entries and other adjustments made during the course of preparing the financial statements (AU-C 330.21.b).

In addition, the auditor should determine whether efficiencies can be achieved by using the concepts of directional testing, as discussed in FAM 470.15 through .18.

- .03 As discussed in FAM 260.02, detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion. Based on the assessed risk of material misstatement, the auditor should determine the nature, extent, and timing of substantive audit procedures to reduce the level of detection risk to an acceptably low level. The auditor determines the level of audit assurance to use for all substantive procedures in order to detect misstatements that in total exceed materiality established in FAM 230.

Audit assurance relates to the entire audit. The auditor should determine the audit assurance needed based on the risk of material misstatement. The higher the risk of material misstatement, the more audit assurance the auditor needs.

For example, for a desired overall audit assurance of 95 percent, GAO auditors generally use the audit assurance for each risk of material misstatement, as indicated in Table 470.1.

**Table 470.1: Risk of Material Misstatement and Minimum Levels of Audit Assurance**

| Risk of material misstatement | Minimum level of audit assurance (percentage) |
|-------------------------------|---|
| Low                           | 63  |
| Moderate                      | 86  |
| High                          | 95  |

## Types of Substantive Procedures

- .04 There are two types of substantive procedures: (1) substantive analytical procedures and (2) tests of details. To achieve the audit assurance as discussed above, the auditor may use either of these tests or a combination of the two. The type of test to use and the amount of reliance to place on each type of procedure is a matter of the auditor's professional judgment, including considerations of audit effectiveness and efficiency. To determine an appropriate mix of substantive procedures, the auditor may use the audit matrix in FAM 470.11.

## Substantive Analytical Procedures

- .05 Substantive analytical procedures involve the auditor comparing a recorded amount with an expectation of that amount and subsequently investigating any significant differences to conclude on the recorded amount. Analytical procedures involve the auditor analyzing plausible relationships among both financial and nonfinancial data. A basic premise is that plausible relationships among data may reasonably exist and continue in the absence of errors, fraud, or changes in circumstances (see AU-C 520).
- .06 The auditor may perform substantive analytical procedures at one of three levels for an assertion, as follows:
- **Complete:** The auditor relies solely on substantive analytical procedures for all of the assurance required from substantive procedures. The procedure is so persuasive that the auditor believes that it is highly likely to detect any aggregate misstatements that exceed performance materiality. Complete assurance from substantive analytical procedures requires procedures that are extremely effective and persuasive to serve as the sole source of audit evidence for achieving the audit objective. This level of effectiveness or persuasiveness is very difficult to achieve when risk of material misstatement is high. Therefore, relying completely on substantive analytical procedures for audit assurance in these situations is rare, particularly for balance sheet accounts.

- **Partial:** The auditor relies on a **combination** of substantive analytical procedures and tests of details to obtain an appropriate level of audit assurance. For partial assurance, the auditor believes that the analytical procedures more likely than not will detect any aggregate misstatements that exceed performance materiality.
  - **None:** The auditor **does not** rely on substantive analytical procedures for audit assurance, and the auditor will obtain assurance from tests of details. In this situation, the auditor may perform supplemental analytical procedures to increase understanding of account balances and transactions but not to provide any additional audit assurance. These procedures are similar in scope to those that the auditor performs on an overall basis at the financial statement level (see FAM 520).
- .07 To determine whether to perform complete or partial substantive analytical procedures, the auditor should evaluate the effectiveness, or persuasiveness and efficiency, of such procedures. In so doing, the auditor may use the factors discussed in FAM 495 A.

### **Test of Details**

- .08 Tests of details are procedures applied to individual items selected by the auditor for testing and include the following:
- **External confirmation** of a balance or transaction or the related terms (such as the terms of payment), by obtaining and evaluating direct communication from a third party, such as for accounts receivable or accounts payable. The auditor should consider whether external confirmation procedures are to be performed as substantive audit procedures (AU-C 330.19). The auditor should use external confirmation procedures for accounts receivable, except when one or more of the following is applicable: (a) the overall account balance is immaterial; (b) external confirmation procedures for accounts receivable would be ineffective; or (c) the auditor's assessed level of risk of material misstatement at the relevant assertion level is low, and the other planned substantive procedures address the assessed risk (AU-C 330.20). The auditor should include in the audit documentation the basis for any determination not to use external confirmation procedures for accounts receivable when the account balance is material (AU-C 330.32). See AU-C 505 for procedures related to external confirmations.
  - **Physical observation** by inspecting, counting, and applying related audit procedures to tangible assets, such as inventory or property, plant, and equipment.
  - **Examination** of supporting documents to determine whether a balance is properly stated, such as examining invoices for expenses and the purchase of inventory and property.
  - **Recalculation** by checking the mathematical accuracy of entity records by footing, cross-footing, or recomputing amounts and tracing journal postings, subsidiary ledger balances, and other details to corresponding general ledger accounts. For example, the auditor may recalculate unit cost extensions in an inventory list, foot the list (whether prepared manually or by computer), and trace the total to the general ledger amount.

- .09 The different types of detail tests are often used in combination to provide sufficient substantive audit assurance about an assertion. For example, to test the valuation/accuracy of accounts receivable, the auditor might confirm balances, recalculate the aging schedule, examine documents supporting the aging and specific delinquent accounts, and discuss collectibility with management. On the other hand, a single detail test might provide audit assurance about more than one of the five financial statement assertions. For example, a physical observation of inventory may provide evidence about existence, valuation/accuracy, and presentation and disclosure.
- .10 The minimum extent of detail testing to be performed is based on the risk of material misstatement and the assurance obtained from substantive analytical procedures, as illustrated in the audit matrix in Table 470.2.

## Determining Mix of Substantive Procedures

- .11 In determining an appropriate mix of substantive analytical procedures and detail tests, the auditor generally should use the audit matrix in Table 470.2, which illustrates the integration of such tests for each level of risk of material misstatement, when the auditor is using a desired overall audit assurance of 95 percent. The audit standards use the term detection risk, which is 1 minus the audit assurance from detail tests.

**Table 470.2: Audit Matrix**

| Assessed risk of material misstatement |    |   |  |
|--|----|---|--|
|  |    | Substantive audit assurance (from Table 470.01) (percentage)        |  |
|  |    | Audit assurance from substantive analytical procedures <sup>a</sup> |  |
|  |    |   | Minimum audit assurance from detail tests (percentage) |
| Low                                    | 63 | Complete  | 0  |
|  |    | Partial   | 50   |
|  |    | None  | 63   |
| Moderate                               | 86 | Complete  | 0  |
|  |    | Partial   | 77   |
|  |    | None  | 86   |
| High                                   | 95 | Complete  | 0  |
|  |    | Partial   | 92   |
|  |    | None  | 95   |

<sup>a</sup>Complete assurance from analytical procedures means that procedures are extremely effective and persuasive to serve as the sole source of audit evidence for achieving the audit objective. This level of effectiveness or persuasiveness is very difficult to achieve when risk of material misstatement is high. Therefore, relying completely on analytical procedures for substantive assurance in these situations is rare, particularly for balance sheet accounts. See FAM 470.06.

- .12 Additional factors to consider in determining an appropriate mix of substantive analytical procedures and detail tests include the following:

- a. **The nature and significance of the assertion being tested:** Analytical procedures are generally more likely to be effective for assertions related to accounts that reflect the audit period's activity, such as accounts included in the statement of net cost, than for accounts related to balance sheet accounts or other cumulative balances. Significant assertions generally require more or higher-quality audit evidence that may not be available from analytical procedures.
  - b. **The nature of the risk of material misstatement:** The auditor should design substantive procedures that address the specific type and level of risk of material misstatement for each assertion. For example, for certain loss claim liabilities, the auditor may design detail tests to search subsequent claim payments for potential liabilities in testing the completeness assertion, while the auditor may use analytical procedures to test the related valuation assertion by evaluating the average amounts per claim.
  - c. **The availability of different types of evidence:** Using evidence that can be readily obtained may be more efficient. For example, in federal government audits, the auditor may use budgets and other information in performing analytical procedures.
  - d. **The quality of the types of evidence available:** The higher the quality of a type of evidence, the greater the level of assurance the auditor may derive from that type (see FAM 470.14).
  - e. **The anticipated effectiveness of substantive analytical procedures:** The auditor should use detail tests if substantive analytical procedures are not expected to be effective.
- .13 When determining the types of substantive procedures to use, the auditor should choose the mix of **effective** procedures that are efficient in combination with sampling control tests and compliance tests.
- .14 When considering a procedure's relative effectiveness, the auditor should evaluate the expected quality of the evidence. The quality of evidence obtained in substantive procedures depends highly on the circumstances under which it is obtained. Some generalizations about evidence are as follows:
- Evidence obtained from independent third parties provides a higher level of assurance than evidence obtained from sources in the entity.
  - Evidence obtained directly by the auditor through confirmation, physical examination, vouching, or recalculation provides a higher level of assurance than evidence obtained indirectly, such as through inquiry.
  - Documentary evidence provides a higher level of assurance than oral representations.
  - Evidence obtained at or near the balance sheet date concerning an asset or liability balance provides a higher level of assurance than evidence obtained before or after the balance sheet date, because the audit risk generally increases with the length of the intervening period.
  - The lower the control risk associated with an entity's internal control, the higher the assurance concerning the information subject to that internal control.

## Directional Testing

- .15 In planning tests, the auditor may use the relationships between recorded amounts to help achieve efficiencies. For example, in double-entry accounting, a misstatement in one account affects at least one other related account. This relationship allows the auditor to test more than one account with a single test. Additionally, the relationship between budgetary and proprietary accounts may allow for efficiencies in testing, for example, for undelivered orders and delivered orders—unpaid for budgetary accounts and expenses and accounts payable for proprietary accounts.
- .16 As stated, in double-entry accounting, a misstatement in one account affects at least one other related account. For example, a misstatement of accrued payroll typically results in a misstatement of payroll expense. In this example, substantive procedures performed on accrued payroll usually will detect any misstatements in both accrued payroll and payroll expense. In designing substantive procedures after considering risk of material misstatement and developing an understanding of each related account, the auditor should determine the effect of tests on related accounts. For example, a test of revenue for completeness may provide substantive evidence about the completeness of accounts receivable.

Where the entity uses double-entry accounting, the auditor may (1) design an overall audit strategy that tests certain accounts substantively for either existence or completeness (the two assertions most affected by testing related accounts) and (2) rely on such tests to detect misstatements in the related accounts. For example, the auditor may test (1) assets and expenses directly for existence and (2) liabilities, equity, and revenue for completeness, thereby indirectly testing the related accounts for existence or completeness, as applicable. This logic is called a directional testing approach.
- .17 In some instances, the auditor may supplement a directional testing approach to address a specific risk of material misstatements. For example, if cutoff is a significant risk, the auditor may test both existence and completeness assertions in a test of cutoff as of the balance sheet date. During initial financial statement audits, the auditor generally should test both existence and completeness directly, when those assertions are significant, because the cumulative knowledge about the interaction of accounts may be limited.
- .18 The audit assurance that can be obtained from directional testing is diminished in balance-sheet-only audits if related accounts are not also tested and in audits of entities having single-entry accounting systems (since double-entry account interrelationships do not exist). In these instances, the auditor should test both existence and completeness directly when those assertions are significant.
- .19 The auditor may combine the testing of budgetary and proprietary accounts when appropriate. For example, the auditor may combine tests of outlays on the statement of budgetary resources with tests of cash disbursements used to test net costs.
- .20 If an entity has budget accounting records but does not maintain separate proprietary accounting records, or the proprietary records are incomplete, the auditor should directly test expended authority produced by the budget system and the items necessary to reconcile the budget to the proprietary accounts.



- .21      Also, if (1) relevant budget restrictions relate to significant quantitative-based provisions of laws and regulations and (2) budget controls are not effective, the auditor should test the accumulated or summarized information directly (see FAM 460.03 through .05).

## **475 – Perform Substantive Analytical Procedures**

- .01 This FAM section provides guidance on the application of substantive analytical procedures. These procedures consist of evaluations of financial information made through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts (AU-C 520.04).

The auditor develops an expectation or estimate of the recorded amount based on an analysis and understanding of relationships between the recorded amounts and other data. This expectation is then used to form a conclusion on the recorded amount. A basic premise underlying analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue unless conditions have changed or the data are misstated. The reasons that make relationships plausible are an important consideration because data sometimes appears to be related when it is not, which may lead the auditor to erroneous conclusions. In addition, the presence of an unexpected relationship may provide important evidence when appropriately scrutinized (AU-C 520.A6). (For further information, refer to AU-C 520 or the AICPA audit guide, *Analytical Procedures*.)

- .02 Scanning account detail and recomputation are two other audit procedures related to substantive analytical procedures. Scanning consists of searching for unusual items in the detail of account balances. Scanning is an appropriate tool for investigating the cause of a significant fluctuation, but it is not a substantive analytical procedure on its own. The auditor should investigate unusual items identified through scanning to obtain substantive audit assurance about the cause of the fluctuation. For example, the auditor identifies an unusual fluctuation in the property balance when performing other substantive procedures. In scanning a detail listing of vehicles, the auditor may find an auto valued at \$600,000, which appears unusually high. Further investigation finds that the decimal point was misplaced when the data was entered, and the vehicle should be recorded at \$6,000.

The auditor may also independently compute an estimate of an account balance, which is sometimes referred to as recomputation or an overall test of reasonableness. These recomputations are considered substantive analytical procedures. When making recomputations, the auditor should assess the reliability of the data used and should follow the steps used for performing substantive analytical procedures. An example is recomputing the amount of depreciation expense on equipment using the accounting method, useful life, and date an asset was placed into service.

- .03 The risk of forming the incorrect conclusion on the account balance tested may be higher for substantive analytical procedures than for detail tests due to the extensive use of the auditor's professional judgment. Accordingly, quality control is of critical importance. To help maintain quality in these procedures, experienced audit team personnel usually perform, or closely supervise and review, the assessment of the reliance to place on procedures, design of procedures, and formulation of conclusions as a result of procedures.

## **Designing and Performing Substantive Analytical Procedures**

- .04 When determining whether performing substantive analytical procedures will be effective and efficient as a substantive test, see FAM 495 A for guidance. In designing and performing substantive analytical procedures, as discussed in AU-C 520.05, the auditor should do the following:
- a. Determine the suitability of particular substantive analytical procedures for given assertions, taking into account the assessed risks of material misstatement and tests of details, if any, for these assertions.
  - b. Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available and controls over preparation.
  - c. Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise (taking into account whether substantive analytical procedures are to be performed alone or in combination with tests of details) to identify a misstatement that individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
  - d. Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations. This is also referred to as the limit. The determination of the limit is a matter of the auditor's judgment, although some guidelines are provided in FAM 475.05.
  - e. Obtain explanations from management for differences that exceed the limit, since such differences are significant. Obtain appropriate audit evidence to corroborate management's explanations for significant differences (AU-C 520.07). This is discussed further in FAM 475.08 through .11.
  - f. Determine whether the explanations and corroborating evidence provide sufficient evidence for the desired level of substantive audit assurance. If unable to obtain a sufficient level of substantive audit assurance from substantive analytical procedures, the auditor should perform additional procedures, as discussed in FAM 475.12 through .17, and evaluate whether the difference represents a misstatement (AU-C 520.07).
  - g. Evaluate whether the assessment of risk of material misstatement remains appropriate, particularly in light of any misstatements identified. Revise the assessment of risk of material misstatement, if necessary, and consider the effects on the extent of detail tests.
  - h. Document on the Schedule of Uncorrected Misstatements (as discussed in FAM 540.05) the amount of any misstatements detected by substantive analytical procedures and their estimated effects. The limit (the amount of the difference between the recorded amount and the expectation that does not require explanation) is not a misstatement and is not posted to the Schedule of Uncorrected Misstatements. The amount of any misstatement does not include the amount of the limit.
  - i. Conclude on the reasonableness of the recorded amount.

- j. Include documentation of work performed, results, and conclusions. See FAM 490.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures. When such controls are effective, the auditor may have greater confidence in the reliability of the information and therefore in the results of analytical procedures (AU-C 520.A19).

## Establishing the Limit

- .05 As discussed above, the limit is the amount of the difference between the expected and recorded amounts that can be accepted without further investigation. The auditor generally should use the following guidelines in establishing the limit for each level of reliance on analytical procedures for substantive audit assurance:
- **Complete reliance:** The limit is 20 percent or less of performance materiality.
  - **Partial reliance:** The limit is 30 percent or less of performance materiality.
  - **No reliance:** *Substantive* analytical procedures are not needed.

Auditors should document the basis for the limit used.

## Investigating Significant Differences

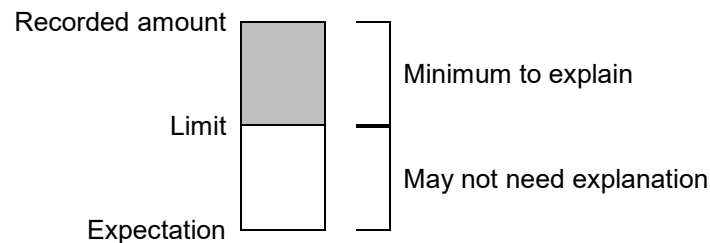
### Causes of Significant Differences

- .06 Differences between the expectation and the recorded amount relate to either factors not included in the model (such as specific unusual transactions or changes in accounting policies), a lack of preciseness of the model, or misstatements (either errors or fraud). The auditor's objective in investigating significant differences is to determine whether they represent misstatements or one of the other factors.

### Amount of Difference to Be Explained

- .07 When obtaining explanations, the auditor should discuss with management the model and assumptions used to develop the expectation. Management will then be in a better position to provide the auditor with a relevant explanation. If the amount of the difference exceeds the limit, the auditor should ask management to provide an explanation for the entire difference between the recorded amount and the expectation. However, the auditor may decide to stop if the explanation covers the portion of the difference that exceeds the limit (see fig. 475.1). If the difference does not exceed the limit, an explanation is not required. The auditor should identify and corroborate all significant factors that cause the expectation to differ from the actual amount, regardless of whether the factors increase or decrease the difference.

**Figure 475.1: Explanations When Recorded Amount Exceeds Limit**



## **Corroboration of Explanations**

- .08 The relevance and reliability of corroborating evidence may vary significantly. Therefore, the extent of corroboration of explanations is left to the auditor's professional judgment. Corroboration may consist of examining supporting documentation or corroborating explanations from personnel in the accounting department and personnel in the appropriate operating department knowledgeable about the entity's operations.

The auditor should quantify and address the direction and magnitude of the event that caused the fluctuation and corroborate explanations received. The auditor should determine whether sufficient corroborating evidence has been obtained based on the guidelines for complete and partial assurance discussed in FAM 470.06. In evaluating explanations, the auditor should also determine whether the difference is caused by error or fraud.

## **Example of an Adequate Explanation for a Significant Fluctuation**

- .09 Assume that the auditor assessed performance materiality to be \$25 million. Additionally, assume that the auditor has determined, after evaluating the risk of material misstatement, to perform a substantive analytical procedure with a limit of \$5 million. The auditor estimated interest expense at \$80 million by multiplying the average loan balance of \$1 billion by an average interest rate of 8 percent. Both of these averages were computed through a simple average of beginning-of-year and end-of-year amounts. The recorded amount of interest expense, \$95 million, is higher than the estimated amount by \$15 million and exceeds the limit by \$10 million.
- .10 An explanation from management that "we borrowed more money this year and interest rates are higher than last year" would not be adequate, as it explains why interest is likely to be higher but not how much higher (it corroborates direction, not amount). The auditor should ask management to quantify the explanation by indicating when interest rates changed and when amounts borrowed changed. The auditor should then corroborate the information provided.
- .11 An example of an adequate explanation follows.
- Management determined that interest rates increased during the year and then fell and were computed to average 9 percent based on the attached monthly weighted average. Additionally, \$100 million was borrowed and repaid during the year, and the additional borrowings were outstanding for 6 months. Therefore,

the average loan balance was actually \$50 million higher and the average interest rate was 1 percent higher than the figures used in the original estimate.

Therefore, 97 percent of the interest expense in excess of the expectation can be explained as follows (in thousands):

|                                |   |    |   |                 |
|--------------------------------|---|----|---|-----------------|
| \$1,000,000                    | X | 1% | = | \$10,000        |
| 50,000                         | X | 9% | = | 4,500           |
| Amount of difference explained |   |    |   | <u>\$14,500</u> |

The auditor examined correspondence from lenders and loan statements to corroborate these explanations. The auditor was satisfied that these covered the significant factors and that it was not necessary to obtain an explanation for the remaining \$.5 million or 3 percent difference. The auditor concluded that interest expense is not misstated and no amounts are posted to the Schedule of Uncorrected Misstatements.

### **Course of Action in the Event of Inadequate Explanations or Corroborating Evidence**

- .12 If an explanation and/or corroborating evidence does not adequately explain the fluctuation sufficiently to provide either complete or partial assurance, the auditor should perform additional substantive procedures or treat the difference as a misstatement. These procedures may consist of
- increasing the effectiveness of the substantive analytical procedures by making the expectation more precise to obtain the desired assurance or
  - performing tests of details and placing no reliance on the ineffective substantive analytical procedures.
- .13 The auditor should determine the effectiveness and efficiency of the above options. Deciding whether to perform additional substantive procedures is a matter of the auditor's professional judgment. The auditor should perform additional procedures to provide adequate assurance that aggregate misstatements that exceed performance materiality have been identified.
- .14 To increase the persuasiveness or effectiveness of an analytical procedure, the auditor may make the expectation more precise by
- building a more sophisticated model by identifying more key factors and relationships,
  - disaggregating the data (such as using monthly instead of annual data),<sup>1</sup> or
  - using more reliable data or obtaining greater confidence in the data's reliability by corroborating the data to a greater extent.

Measuring the precision of the expectation and the impact of changing each of these factors on the procedure's effectiveness is difficult. The auditor may consult with an expert in this field.

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<sup>1</sup>If data are disaggregated, the limit is still applied on an annual basis.

### **Performing Supplemental Analytical Procedures**

- .15 If detail tests are used to test the account balance because adequate explanations cannot be obtained or corroborated, the auditor still should obtain an overall understanding of the current-year financial statements when applying overall analytical procedures at the financial statement level. See FAM 520.
- .16 Additionally, if analytical procedures originally performed as a substantive test do not provide the necessary assurance, the auditor may use those procedures to supplement an understanding of the account balances or transactions after performing detail tests.
- .17 When the auditor places no reliance on substantive analytical procedures, all assurance is provided by detail tests. In this situation, the auditor may use supplemental analytical procedures to increase the auditor's understanding of the account balances and transactions after performing the detail tests. When using supplemental analytical procedures, the auditor uses professional judgment to determine which fluctuations to obtain explanations for and which explanations to corroborate.

## **480 – Perform Substantive Detail Tests**

### **Population to Be Tested**

- .01 In defining the population, the auditor should identify the whole set of items on which the auditor needs to reach a conclusion and from which the sample will be drawn. This includes describing the population; conducting data reliability tests to determine whether the population is complete and valid; determining the source document or the transaction documents to be tested; and defining the period covered by the test. The auditor should analyze the population for characteristics such as large and/or unusual balances, duplicate items, and abnormal balances. In designing detail tests, the assertion tested affects the choice of the population (an account balance or a portion of an account balance) from which items are selected. For example, the existence assertion deals with whether recorded assets or liabilities exist as of a given date and whether recorded transactions have occurred during a given period. To detail test the existence assertion, the auditor should test the recorded account balance by
- selecting items from those that compose the account balance and
  - testing those items to evaluate whether including them in the account balance is proper.

For example, to test an expense account for existence, the auditor may select from a detailed general ledger individual expense amounts included in the balance and then examine invoices that support the expense amount. It would be inappropriate to select invoices directly and then trace invoice amounts to inclusion in the general ledger balance.

- .02 For the existence assertion, the auditor should determine if the population agrees with or is reconciled to the recorded amount of the account balance being tested. The auditor should test reconciling items, if any, in an appropriate manner. If this is not done, the auditor can conclude only on the population tested and not on the recorded population.
- .03 Conversely, the completeness assertion deals with whether all transactions and accounts that are expected to be in the financial statements are included. To detail test the completeness assertion, the auditor should select from an independent population of items that are expected to be recorded in the account. The auditor should (1) select items from a source that is likely to contain all the items that are expected to be recorded and (2) determine whether they are included in the recorded balance.

For example, to test completeness of recorded revenue, the auditor may select shipments from a shipping log (which is believed to be reasonably complete), trace them to recorded revenue amounts, and then test whether the summarization of those amounts was included in the general ledger revenue balance.

To test completeness of recorded accounts payable, the auditor may select payments made subsequent to year-end plus invoices on hand but not yet paid. The auditor may then trace transactions for which the receipt of goods or services occurred before year-end for inclusion in year-end accounts payable.



For those transactions where the receipt occurred after year-end, the auditor should test for exclusion from accounts payable.

## Selection Methods for Detail Tests

.04 The auditor may apply detail tests to any of the following:

- all items composing the population,
- a nonrepresentative selection (nonsampling selection) of items, and
- a representative selection (sample) of items composing the population.

Flowchart 1 in FAM 495 E illustrates the process of deciding the selection method.

.05 Detail testing of **all items composing the population** is generally most appropriate for populations consisting of a small number of large items. For example, several large accounts receivable or investments might compose an entire balance.

.06 Detail testing of **a nonrepresentative selection (nonsampling selection)** is appropriate where the auditor knows enough about the population to identify a relatively small number of items of interest, usually because they are likely to be misstated or otherwise have a high risk of material misstatement. The auditor also uses nonrepresentative selections to test controls through inquiry, observation, and walk-through procedures and to obtain planning information, for example, by performing a walk-through to understand the items in the population.

While the dollar amount is frequently the characteristic that indicates that an item is of interest, other relevant characteristics might include an unusual nature (such as an item identified on an exception report); an association with certain entities (such as balances due from high-risk, financially troubled entities); or a relationship to a particular period or event (such as transactions immediately before and after the year-end).

The auditor should evaluate the effects of any misstatements found in the nonrepresentative selection. However, unlike sampling, the results of procedures applied to items selected under nonsampling selection apply only to the selected items. **It is incorrect for the auditor to project the results to the portion of the population that was not tested.** Accordingly, the auditor should apply appropriate substantive analytical procedures and/or other substantive procedures to the remaining items, unless those items are immaterial in total or the auditor has already obtained enough assurance that there is a low risk of material misstatement in the untested population through other audit procedures.

.07 Detail testing of **a representative selection (sample) of items composing the population** is necessary when the auditor cannot efficiently obtain sufficient assurance (based on the assessed risk of material misstatement and other substantive procedures, including analytical procedures) about the population from nonrepresentative selections. AU-C 530 indicates that samples may be either statistical or nonstatistical.

The auditor should select items for the sample in such a way that the auditor can reasonably expect the sample to be representative of the relevant population and likely to provide the auditor with a reasonable basis for conclusions about the population (AU-C 530.08). The auditor should select the sample so that each

item in the population has an opportunity to be selected. The auditor should project the results of the procedures performed to the entire population. In random selection, each item has an equal chance of selection (see glossary for definition). For MUS, each monetary unit (dollar) has an equal chance of selection. For classical variables estimation sampling, each item in a stratum has an equal chance of selection.

- .08 The auditor may use a nonrepresentative selection for part of the population and a sample for the remainder of the population. For example, the auditor may select all inventory items with a book amount greater than \$10,000,000 and all items that have not had any activity in the previous 6 months for nonrepresentative sampling, and perform a statistical sample of the balance of the population. The auditor is able to project any misstatements found in the statistical sample to the population of items less than \$10,000,000 with activity in the last 6 months. The auditor is also able to compute a combined evaluation for the three selections by adding the results of the two 100 percent selections to the results of the statistical sample selection.
- .09 The auditor should document (usually in audit procedures) whether a selection is intended to be a representative selection (a sample projectable to the population) or a nonrepresentative selection (not projectable to the population). If it is a nonrepresentative selection, the auditor also should document the basis for concluding that enough work has been done to obtain sufficient assurance that the items not tested are free from aggregate material misstatement.

### **Representative Selections (Sampling)**

- .10 The following paragraphs through FAM 480.20 provide an overview of sampling, primarily with respect to the existence and valuation assertions. Similar concepts and methods apply to the completeness assertion, except that the population to be tested differs, as discussed in FAM 480.01 through .03.
- .11 In statistical sampling, the auditor uses probability theory to determine sample size, select the sample, and evaluate the results to reach a conclusion about the population. Statistical sampling permits the auditor to objectively determine sample size (based on subjective decisions about risk and materiality), objectively select the sample items, and objectively evaluate the results. Thus, by using statistical sampling the auditor determines objectively whether enough work has been performed. When sampling, the auditor should determine a sample size sufficient to reduce sampling risk to an acceptably low level (AU-C 530.07).
- Because of these advantages, when a sample is necessary, the auditor generally should use statistical sampling. Software such as IDEA allows the auditor to quickly perform the calculations necessary for statistical sampling.
- .12 In nonstatistical sampling, the auditor considers statistical concepts, but does not explicitly use them to determine sample size, select the sample,<sup>1</sup> or evaluate

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<sup>1</sup>Usually, the auditor applying nonstatistical sampling will select a “haphazard sample.” A haphazard sample is a sample consisting of sampling units selected without conscious bias, that is, without any special reason for including or excluding items from the sample. It does not consist of sampling units selected in an arbitrary manner; rather it is selected in a way the auditor expects to be representative of the population.

Since a haphazard sample is not the same as a statistical sample, the auditor using a haphazard sample cannot calculate precision at a given confidence level. However, AICPA guidance indicates that the auditor may use the

results. Because the auditor using statistical sampling objectively evaluates the same factors that the auditor using nonstatistical sampling subjectively evaluates, the auditor should not use a nonstatistical sample that is less than the size of a properly calculated statistical sample.

- .13 The auditor who uses nonstatistical sampling first calculates a statistical sample's size using MUS then subjectively adds a factor because (1) a nonstatistical sample is not as objective as a statistical sample and (2) the MUS would have been selected proportionate to size while the auditor might not select the nonstatistical sample proportionate to size. There is no guidance on how much to add. It depends primarily on how homogeneous or heterogeneous the population is and on whether the auditor first stratified the population. For heterogeneous unstratified populations, the auditor may double the statistical sample size. For relatively homogeneous populations that have been stratified, the auditor may use 1.25 to 1.5 times the statistical sample size and allocate the sample size proportionate to the strata size. **The auditor who uses nonstatistical sampling for a particular test should obtain the approval of the reviewer, in consultation with the audit sampling specialist, before performing the test.**
- .14 In sampling, the auditor should select the sample from all the items that compose the population so that each item has an opportunity for selection. In statistical sampling, the auditor can determine the probability of selection. For example, the auditor may select sample items from a list of all accounts receivable balances that is reconciled to the related general ledger account balances. Selecting sample items from file drawers is not a valid selection method for any type of sampling unless the auditor has determined that the file drawers contain all items composing the population.
- .15 For statistical samples, the auditor generally should select sample items using either random or MUS methods. The auditor may use computer software to select the samples. For example, IDEA offers two methods of selecting a sample where the auditor generally should use the cell method rather than the fixed interval method. In the cell method, the program divides the population into cells such that each cell is equal in size to an interval. Then, the program selects a random dollar in each cell. The random dollar selected identifies the transaction, account, or line item to be tested (sometimes called the logical unit).
- .16 The sample size is a function of the size of the population, the auditor's assessment of the risk of material misstatement; desired confidence level (based on the amount of substantive audit assurance that the auditor requires from detail tests, as shown on the audit matrix in FAM 495 D, tolerable misstatement, expected misstatements in the population, and other factors discussed in FAM 230.13); and the sample selection method (AU-C 530.A13).
- .17 Once the auditor decides that a sample is necessary, the choice of the sampling method is a matter of the auditor's professional judgment about the most efficient

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haphazard sample to make a judgment of what a statistical sample might have shown. For example, the auditor may use the haphazard sample to make a judgment as to the misstatement in areas that are not very significant. Even though the judgment will not be a statistical projection, it may assist the auditor in determining whether the possible misstatement could be material.

Professional standards and the FAM do not use "judgment sample." All selections (including statistical selections) require judgment. The term judgment sample is often used to refer to nonrepresentative selections, although it sometimes refers to nonstatistical samples.

method for achieving the audit objectives. Sampling methods available for substantive procedures are

- MUS (see FAM 480.21);
- classical variables estimation sampling (see FAM 480.27); and
- classical probability proportional to size (PPS) sampling, evaluating a PPS sample using a classical variables sampling approach (see FAM 480.29).

The auditor may use attribute sampling for tests of controls and for tests of compliance with applicable laws, regulations, contracts, and grant agreements. For example, the auditor may select a MUS of expenditure transactions for testing and include testing the sample for approvals, for entry into the general ledger, and for compliance with applicable provisions of the Prompt Payment Act. It should be noted that multipurpose tests may not be efficient if they are conducted during the first 2 years of a new audit, as the auditor may not be as aware of the operating effectiveness of the controls in place at an entity in a new audit and the rate of deviation may be higher than expected. In order to use a MUS for a multipurpose test, there should be at least 45 unique transactions selected to meet the minimum control sample size requirements in FAM 450.

For classical variable estimation sampling, stratification and/or use of ratio estimates and regression estimates often lead to smaller sample sizes. Multistage samples may reduce time and travel costs. The auditor should consult with the audit sampling specialist before using this sampling method.

- .18 Each of these sampling methods yields a projected (likely) misstatement and an upper limit at the desired confidence level. In addition, classical PPS and classical variables sampling both yield a two-sided confidence interval (MUS yields an upper limit). The auditor should choose the appropriate method based on the test objectives and efficiency.
- .19 When deciding the sampling method, the auditor should determine whether the monetary amounts of the individual items composing the population are available (for example, on a detail listing or in a computer file); the expected amount of misstatements; and the relative efficiency of each appropriate sampling method. Flowchart 2 in FAM 495 E summarizes the process for choosing the sampling method once the auditor has decided a sample is necessary. The subsequent pages of the flowchart indicate the steps that the auditor generally should perform for each sampling method. Example audit documentation for attribute sampling, MUS, and classical variables sampling can be found in FAM 495 E.
- .20 If the dollar amounts of the individual items composing the population are known, the auditor should use MUS, classical PPS, or classical variables estimation sampling. If dollar amounts of individual items are not known, see FAM 480.31.

## Sample Selection

### MUS

- .21 MUS is a type of statistical sampling that the auditor generally should use when
  - the monetary amounts of individual items in the population are known,

- the primary objective is to test for overstatement of the population (see below for testing a population related to the line item),
- the auditor expects that the total monetary amount of misstatement in the population is not large,<sup>2</sup> and
- the amount of misstatement in an individual item cannot exceed the selected amount.<sup>3</sup>

MUS is also known as PPS and as dollar unit sampling. MUS works best in populations where the total misstatement is not large and where the objective is to test for overstatement of a population. When the objective is to test for understatement of a line item, the auditor often is able to define a related population to test for overstatement. For example, to test for understatement of accounts payable, the auditor may select an MUS of subsequent disbursements. See also FAM 480.31.

- .22 When the total misstatement in the population is not large, MUS will yield the smallest sample size for a given population, tolerable misstatement, and desired confidence level when all statistical sampling methods are considered. If the auditor expects that the population contains a large amount of misstatement, the auditor generally should use classical variables sampling (see FAM 480.27).

### **Computation of MUS Size**

- .23 When the auditor uses IDEA to calculate MUS size, the inputs are materiality, tolerable error, expected error, expected total (dollar) amount of misstatements in the population, confidence level, and the (dollar) amount of the population.
- .24 The auditor should perform audit procedures, appropriate to the purpose, on each item selected (AU-C 530.09). If the audit procedure is not applicable to the selected item, the auditor should perform the procedure on a replacement item (AU-C 530.10).
- .25 If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor should treat that item as a deviation from the prescribed control (in the case of tests of controls; see FAM 450) or a misstatement (in the case of tests of details) (AU-C 530.11). If this is the case, see further explanation at FAM 450.19.
- .26 If additional sample items are not selected during the initial sample and it is necessary to select additional and or replacement items, the auditor should consult with the audit sampling specialist to determine how to select the

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<sup>2</sup>This expectation affects the efficiency of the sample, not its effectiveness. GAO auditors who use IDEA to calculate sample size (based on the hypergeometric probability distribution) use classical variables estimation sampling when they expect that more than 30 percent of the sampling units contain misstatements (no matter what the size of the misstatement). When GAO auditors expect that 10 percent or fewer of the sampling units contain misstatements, GAO auditors use MUS. When GAO auditors expect between 10 and 30 percent of the sampling units contain misstatements, GAO auditors consult with the audit sampling specialist. The auditor, in consultation with the audit sampling specialist, generally should determine whether to use classical PPS to evaluate the sample to obtain a smaller precision, if a large misstatement rate is found. Other auditors, in consultation with their audit sampling specialists, may use different rules in deciding when to use MUS versus classical variables estimation sampling.

<sup>3</sup>This means, for example, that an item that has a selected amount of \$1,000 cannot be misstated by more than \$1,000. This is not an issue in testing existence (overstatement) or valuation (overstatement). However, it might be an issue in testing completeness (understatement) or valuation (understatement). Thus, if understatements larger than the selected amount are expected, the auditor generally should use classical variables estimation sampling.

additional sample items. Selection of these additional items may be more complex and less efficient than if they were chosen during the initial sample.

### **Classical Variables Estimation Sampling**

- .27 Classical variables estimation sampling is a type of statistical sampling that may be used when the auditor expects that one or more conditions exist in the population, such as:
- the dollar amount of misstatement in the population is large (see footnote 3),
  - individual misstatements may exceed the selected amount of sampling units,
  - significant understatements cannot be identified using other tests,
  - there are no book amounts for each sampling unit, or
  - the auditor cannot add the dollar amounts in the population (see flowchart 2 in FAM 495 E).
- .28 Classical variables estimation sampling is useful because it frequently results in smaller sample sizes in higher misstatement situations than those that would be obtained using MUS. Because applying this method is somewhat complex, the auditor should consult with the audit sampling specialist before using it. Both this method and classical PPS sampling discussed in FAM 480.29 require knowledge of the population to determine sample size. In many audits, the auditor learns about the population over several audits and may use this knowledge to refine the sampling methodologies to improve efficiency.

### **Classical PPS Sampling**

- .29 Classical PPS sampling is a type of statistical sampling that the auditor generally should use when testing for overstatement of the defined population and expects a large misstatement rate. Since there is no exact way to determine sample size, the auditor uses MUS to calculate sample size (proportional to size). However, since classical PPS sampling is used when there are large misstatement rates, the auditor should use a conservative (high) estimate of the expected misstatement to avoid needing to subsequently expand the sample size to obtain a sufficient sample size.
- .30 Classical PPS sampling yields a valid measure of projected misstatement and precision and is easier to design and evaluate than classical variables estimation sampling. Thus, in higher misstatement situations, the auditor may choose to use classical PPS sampling if there are not reasons other than an expected high misstatement rate for using classical variables estimation sampling.

### **Sampling When Dollar Amounts Are Not Known**

- .31 The auditor cannot use MUS if the dollar amounts of individual items in the population are not known. The auditor may use classical variables estimation sampling, but this method has some difficulties. There is no way to accurately calculate the sample size without the individual dollar amounts, and the method is inefficient unless the auditor finds a large misstatement rate. The lack of individual dollar amounts usually occurs when testing the completeness assertion where the selection is made from a population independent of the population

- being tested, such as a shipment from a shipping log (see FAM 480.01 through .03). One approach may be for the auditor to select a random or systematic sample of the individual items. For example, the auditor may randomly select items from a shipping log to test the completeness/cutoff assertion for revenue and accounts receivable that shipments have been billed in the proper period.
- .32 For this type of test, the sample size may be approximated from the total (dollar) amount of either the population from which the auditor is sampling (the total dollars of the shipping log if the log has amounts), or the amount of the population that the auditor is testing (the total recorded revenue). Because this method is less efficient than MUS, the auditor generally should use a preliminary estimate of sample size that exceeds the sample size that would result from using MUS, for example, at least a 25 percent increase in sample size.<sup>4</sup>
- .33 The auditor should consult with the audit sampling specialist to determine whether to use classical variables estimation sampling and to perform the evaluation. In using attribute sampling for substantive tests, the auditor generally should use the upper limit of the misstatement rate to make a conservative estimate of the dollar amount of misstatement in the population. If the upper limit is less than materiality, the auditor has evidence that the population is free of material misstatement.

## Evaluation of Sample Results

- .34 Evaluation of sampling results, including sampling risk should involve (AU-C 530.14) the following:
- Projecting the results of the sample to the population (for nonstatistical samples, making a judgment about any deviations/misstatements in the population) (AU-C 530.13).
  - Calculating either the upper limit of misstatement in the population or an interval estimate of misstatement or of the population audited value at the desired confidence level (for nonstatistical samples, considering the risk of further misstatement).
  - Determining any qualitative aspects of the deviations/misstatements.
  - Bringing deviations/misstatements to management's attention.
  - Asking management to correct factual misstatements and determine the cause of the deviation/misstatement.
  - Concluding as to whether the population is free from material misstatement, after management's adjustments, if any.
  - Evaluating the effect of misstatements on the financial statements taken as a whole.

The auditor usually completes the first two steps above with software such as IDEA. The auditor should perform the evaluation in consultation with the audit sampling specialist.

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<sup>4</sup>The 25 percent is a rough estimate that is used because the auditor cannot calculate the correct sample size.

- .35 The effects of any misstatements detected in a sample are projected to the population. The auditor should investigate the nature and cause of any deviations or misstatements identified and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit (AU-C 530.12). The auditor should project all misstatements unless **highly persuasive evidence** is obtained that a misstatement is not representative of the entire population. If the evidence is highly persuasive that a misstatement is not representative of the population, the auditor should
- perform procedures to test that the same type of misstatement does not exist elsewhere in the population;
  - evaluate the misstatement that is not representative;
  - evaluate the sample, excluding the misstatement that is not representative; and
  - obtain the approval of the audit director that the evidence is highly persuasive.
- The projected misstatement amount is included in the Example Schedule of Uncorrected Misstatements in FAM 595 C (example 1), the evaluation of which is discussed in FAM 540.
- .36 At the conclusion of the test, the auditor also should determine whether the assessment of risk of material misstatement remains appropriate, particularly in light of any misstatements identified. If the preliminary risk of material misstatement assessment was not appropriate, the auditor should consult with the reviewer to determine whether the extent of substantive procedures is adequate.
- .37 When understated amounts are detected in any sample designed primarily to test the existence assertion (i.e., designed to test primarily for overstatement), the auditor should consult with the audit sampling specialist in evaluating the sample results.

### **Calculating the Projected Misstatement for MUS**

- .38 If the auditor does not use software to evaluate sample results, the auditor should calculate projected misstatement as follows. For a misstatement detected in which the item equals or exceeds the amount of the sampling interval (each of which is selected for testing), the projected misstatement is the amount of the misstatement detected. For any other misstatement detected, the projected misstatement is computed by
- dividing the amount of misstatement by the recorded amount of the sample item and
  - multiplying the result by the amount of the sampling interval.
- The sum of all projected misstatements represents the aggregate projected misstatement for the sample. For example, assume the following two misstatements are detected in a sample for which the sampling interval is \$300,000: (1) a \$50,000 misstatement detected in a \$500,000 item (which exceeds the amount of the sampling interval) results in a projected misstatement of \$50,000 and (2) a \$100 misstatement in a \$1,000 sample item represents a 10



percent misstatement, which results in a projected misstatement of \$30,000 (10 percent of the \$300,000 sampling interval). In this example, the aggregate projected misstatement is \$80,000.

### **Evaluating a MUS as a Classical PPS Sample**

- .39 If a MUS results in a large number of misstatements, it is likely that the evaluation based on using the calculating method illustrated above would indicate that the upper limit of misstatement in the population exceeds materiality (IDEA indicates the number of misstatements that would yield acceptable results). However, if there are a large number of misstatements,<sup>5</sup> the auditor, in consultation with the audit sampling specialist, generally should evaluate the sample using classical PPS sampling. This evaluation is complex and cannot be done directly using IDEA.

### **Evaluating the Results of a Classical Variables Estimation Sample**

- .40 The auditor should consult with the audit sampling specialist in evaluating the results of a classical variables estimation sample.

### **Evaluating the Results of Other Samples**

- .41 When the auditor detects misstatements in a sample for which guidance on evaluation is not described above, the auditor should consult with the audit sampling specialist.

## **Effects of Misstatements on the Financial Statements**

- .42 The auditor should evaluate the quantitative and qualitative effects of all misstatements detected in the audit in relation to the financial statements taken as a whole. FAM 540 and 545 provide guidance on this evaluation.

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<sup>5</sup>As a general rule, this means 10 misstatements if the sample size is from 75 to 100, 10 percent if the sample size is from 100 to 300, and 30 if the sample size is over 300. Minimum sample size for classical PPS sampling is 75.

## **490 – Prepare Documentation**

- .01 The auditor should document the nature, extent, and timing of procedures performed during the testing phase of the audit, as well as the results and conclusions reached.<sup>1</sup> The auditor should document how these procedures respond to the assessed risk of material misstatement at the relevant assertion level (as discussed in AU-C 330.30). The auditor should also specifically identify the procedures used to obtain substantive audit assurance for an account balance, for example, when the auditor relies on detail tests for complete substantive audit assurance and performs supplemental analytical procedures to increase the auditor's understanding of the account balances and transactions. The auditor may document the procedures performed, results, and conclusions in summary memos by cycle area.
- .02 In order to focus on key matters and identify significant exceptions, the auditor generally should document in the planning audit documentation the audit objectives, procedures to be performed, possible exceptions, and why they may be important.
- .03 The auditor also should document, usually in the applicable audit plan with the audit procedures, whether a selection is intended to be a representative selection (a sample projectable to the population) or a nonrepresentative selection (not projectable to the population). If it is a nonrepresentative selection, the auditor should document the assessment of the risk of material misstatement for the items not tested as part of the selection and the basis for concluding that enough work has been done to obtain sufficient assurance that the items not tested are free from aggregate material misstatement.
- .04 As audit work is performed, the auditor may become aware of possible material weaknesses, other significant deficiencies, other control deficiencies, identified or suspected noncompliance, or other matters. The auditor should document and communicate these issues, as described in FAM 580.43 through .73.
- .05 The auditor should document the elements included in FAM 495 E, which include the items below. (GAO auditors generally should use FAM 495 E and provide it to the auditing sampling specialist).
  - a. For tests involving sampling, the auditor should document the following:
    - the sampling method used;
    - the sample size and the method of determining it;
    - how the sample was selected;
    - a list of items tested;
    - the audit procedures performed; and
    - the results of tests, including evaluations of sample results, and conclusions.

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<sup>1</sup>In cases where the auditor is relying on professional judgment, the auditor's decisions should be documented and supported.

- b. For substantive analytical procedures, the auditor should document the following:
- the model used to develop the expectation and the basis for the model, including the expectation referred to in FAM 475.04 and the factors considered in its development when that expectation or those factors are not otherwise readily determinable from the audit documentation (AU-C 320.08.a);
  - the data used and the data sources;
  - the auditor's assessment of the reliability of the data used and procedures performed to establish or increase the amount of reliability, if applicable;
  - the amount of the limit and the criteria for establishing the limit;
  - results of the comparison of the recorded amounts, or ratios developed from recorded amounts, with the expectations;
  - results of the comparison referred to in FAM 475.04 of the recorded amounts, or ratios developed from recorded amounts, with the expectations (AU-C 320.08.b), including management's explanations for significant fluctuations, sources of these explanations, and corroborating evidence obtained;
  - any additional auditing procedures performed relating to the investigation of fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount and the results of such additional procedures (AU-C 320.08.c); and
  - conclusions regarding findings, including treatment of any misstatements detected and assessment of any other effects of these misstatements.
- c. The auditor should document interim testing procedures (see FAM 495 C for documentation guidance).
- d. The auditor should document individual and total misstatements on the Schedule of Uncorrected Misstatements. See FAM 595 C.
- e. For audit procedures related to the inspection of significant contracts and grant agreements, the auditor should include abstracts or copies of those contracts and grant agreements in the audit documentation (AU-C 230.10).

Determining whether an inspected contract or grant agreement is significant is a matter of auditor judgment. In making this determination, the auditor may find it necessary to consult with OGC to gain a better understanding of the contract or grant agreement.

If a contract or grant agreement is deemed to be significant, the auditor should include information about the contract or grant agreement in the audit documentation. At a minimum, the audit documentation should include abstracts or copies of significant contracts and grant agreements examined if they are needed to allow an experienced auditor to understand the work performed and conclusions reached. The following considerations may help guide the auditor in determining whether a contract or grant agreement is significant and whether to obtain and maintain an abstract or copy in the audit documentation.

- Risk – Matters arising from contracts or grant agreements that an auditor considers to be a significant risk. Factors in making that determination include complexity, uniqueness, congressional or public interest, and whether it is outside the normal course of business.
  - Materiality – Individual or classes of contracts or grant agreements that are individually or collectively material, considering both quantitative and qualitative materiality. If there is a class of similar contracts or grant agreements, the auditor may determine that only examples of such contracts or grant agreements or abstracts summarizing the class are necessary to include in the audit documentation. Factors in making this determination include transactions and balances recorded under a contract or grant agreement that are material to the financial statements, and contracts or grant agreements that are significant or fundamental to the operations of the entity.
  - Disclosure – Matters or transactions arising from contracts or grant agreements that could be disclosed in the financial statements, notes, required supplementary information or required supplementary stewardship information, and other information.
  - Internal control over financial reporting – Internal controls over financial reporting that the auditor has determined are key, especially those performed by service organizations.
  - Auditor's report – Issues or transactions arising from contracts and grant agreements that the auditor has determined to be significant and included in the auditor's report as emphasis-of-matters or other-matters.
- f. For accounting estimates, the auditor should document the following (AU-C 540.22):
- with significant risk, the basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure and
  - indicators of possible management bias, if any.

## **495 A – Determine Whether to Perform Substantive Analytical Procedures**

- .01 When determining whether performing substantive analytical procedures will be effective and efficient as a substantive test, the auditor should evaluate the
- nature of the account balance, the audit objective (including the assertions being tested), and the assessed risk of material misstatement (FAM 495 A.02 through .04);
  - expected availability and reliability of explanations for fluctuations and related corroborating evidence (FAM 495 A.05);
  - plausibility and predictability of the relationship (FAM 495 A.06 through .13);
  - availability and reliability of data (FAM 495 A.14 through .22); and
  - preciseness of the expectation (FAM 495 A.23 through .25).

This FAM section provides additional guidance to the auditor in these areas.

### **Nature of the Account Balance, the Audit Objective, and the Assessed Risk of Material Misstatement**

- .02 Analytical procedures are usually more effective for testing accounts that accumulate transactions for the period, such as statement of net cost accounts, than for testing balance sheet accounts. This is because balance sheet amounts are more difficult to predict as they are as of a specific point in time. Additionally, net cost statement amounts generally have relationships with other data, such as cost of sales as a percentage of sales, interest expense as a function of the debt balance and interest rates, or sales revenue as a function of the number of units shipped and the average sales price. Analytical procedures are usually less effective for testing amounts that are subject to management discretion or are unpredictable, such as repairs or miscellaneous expenses.
- .03 The auditor should use the audit objective, including relevant assertions, and the assessed risk of material misstatement to determine whether substantive analytical procedures will be effective. The auditor can obtain three levels of substantive assurance from analytical procedures—complete, partial, or none. The effectiveness and the amount of assurance provided by an individual procedure are matters of the auditor’s professional judgment and are difficult to measure.
- .04 When the risk of material misstatement is high, the auditor will rarely be able to place complete reliance on analytical procedures for substantive assurance, particularly for balance sheet accounts. Therefore, in these cases, the auditor should design analytical procedures that are extremely effective and persuasive, if they are to serve as the sole source of audit evidence for achieving the audit objective.

### **Explanations for Fluctuations and Corroborating Evidence**

- .05 Explanations for fluctuations and related, reliable corroborating evidence may not be readily available. This evidence is essential when the auditor uses analytical

procedures as a substantive test. The auditor could consider the relative ease of obtaining explanations for significant differences and relevant, reliable corroborating evidence when determining whether analytical procedures will be effective.

## Plausibility and Predictability of the Relationship

- .06 Relationships between the amount being tested (the recorded amount) and the other data are an essential component of substantive analytical procedures. The auditor should identify relationships that are good indicators of the account balance, that is, the relationship between the recorded amount and the other data is plausible and predictable.

### Plausibility

- .07 If one set of data provides a reasonable basis for predicting another set of data, the relationship between the two sets of data is plausible. As the plausibility of the relationship increases, so does the effectiveness of analytical procedures as a substantive test.
- .08 For example, there is a plausible relationship between payroll expense, the average number of employees, and the average pay rate. This relationship generally is effective for the auditor to use in developing an expectation for payroll expense of salaried employees. Alternatively, there is not usually a plausible relationship between revenue and interest expense. Therefore, this relationship would not be used for developing an expectation.

### Predictability

- .09 The more predictable the relationship is, the more effective the substantive analytical procedure will be. Relationships are more predictable in a stable environment. As relationships become more complex because of increases in the number and type of contributing factors, related amounts become more difficult to effectively and efficiently predict.
- .10 For example, payroll expense generally is very predictable if there is little employee turnover during the period, if all employees receive the same percentage raise at the same time, and if all employees are salaried. Payroll expense becomes more difficult to predict if any of these factors changes, such as high turnover resulting in a different mix of employee pay, a wide range of raises awarded at different times, or a mix of hourly and salaried employees. Therefore, to effectively estimate payroll expense, the auditor may need to use a more complex relationship that considers these factors.
- .11 The relationships may be between the recorded amount and either prior-year or current-year data, using financial or nonfinancial data, including underlying business factors. For example, the auditor may determine an expectation for (1) current-year interest expense using current-year **audited**, long-term debt amounts and interest rate information or (2) estimating budgetary gross outlays based on known relationships with related audited proprietary accounts, such as operating expenses, payables, and capital acquisitions, and comparing this amount to the balance reported on the Statement of Budgetary Resources.
- When using current-year relationships, the auditor should test the data**

**used to develop the expectation by a method other than a substantive analytical procedure that uses a relationship with the recorded amount.**

- .12 The auditor should develop a rationale for using prior-year amounts as the only basis for the expectation. The auditor should document why, in the auditor's professional judgment, the prior-year amount, and any adjustments to that amount, have a plausible and predictable relationship with the current-year recorded amount. The auditor could consider testing any adjustments to the prior amount, such as for the effects of inflation. Additionally, the auditor should determine whether the prior-year amount is reliable. The easiest way to determine this is if the prior-year amount is audited.
- .13 For an example of prior-year relationship, assume that the payroll raises for the current year were authorized at 5 percent and that the number and salary mix of employees have remained relatively stable. In this example, the auditor may reasonably expect current-year payroll expense to be 5 percent higher than the prior year's payroll expense. However, the auditor would need to test the reliability of the percentage pay increase and the assumptions regarding the number and mix of employees.

## **Data Considerations**

### **Availability of Data**

- .14 Data needed to perform analytical procedures as a substantive test may not be readily available. The auditor generally should determine when data will be available and the relative ease of obtaining relevant, reliable data when determining whether analytical procedures will be efficient and effective.

### **Reliability of Data**

- .15 The more reliable data are, the more effective analytical procedures will be as a substantive test. In assessing the reliability of data, which is a matter of the auditor's professional judgment, the auditor should evaluate
- the source of the data, including whether the data are audited or unaudited;
  - conditions under which the data were developed and gathered, including related internal controls; and
  - other knowledge the auditor may have about the data.

### **Sources of Data**

- .16 Data obtained from an independent source outside the entity are generally more reliable than data obtained from inside the entity. However, the auditor should determine if the outside information is comparable to the item being tested. This issue of comparability is important if the auditor is using industry statistics.
- .17 Data obtained from entity sources are more reliable if the sources are independent of the accounting function and if the data are not subject to manipulation by personnel in the accounting function. If multiple data sources are used, the auditor should determine the reliability of all sources used.

### **Audited versus Unaudited Data**

- .18 The auditor should determine whether the data are audited or unaudited because audited data are more reliable than unaudited data. (See FAM 600 on using the work of others.)
- .19 Unaudited data are not reliable unless the auditor performs procedures to establish their reliability. These procedures could consist of either evaluation and tests of controls over data production or tests of the data. The extent of such procedures is a matter of professional judgment and should be documented. For example, interest rates from an entity's loan register may be used to estimate interest income. The reliability of this information may be established by including the interest rate on loan confirmations that are sent to the borrowers or by reviewing original loan documents.

### **Conditions under Which the Data Were Gathered**

- .20 Another consideration for internal data is whether the data were developed under a reliable system with adequate financial reporting or operations controls. The auditor may test operations controls to assess the reliability of the data used for substantive analytical procedures. The extent of this testing is a matter of the auditor's professional judgment.
- .21 If the system used to develop internal data is computerized rather than manual, the auditor should perform additional procedures before relying on the data. The auditor should test either (1) the general controls and the specific application controls over the information system that generated the report or (2) the data in the report.
- .22 An auditor may test operations controls when using entity-prepared statistics for a substantive analytical procedure. For example, the auditor may use Air Force statistics to test the reasonableness of its Airlift Services' aircraft operating costs. The auditor may compare the per hour fuel and maintenance costs for Airlift Services' cargo and passenger aircraft with the "block hour" costs incurred by major airlines for similar aircraft, as published in *Aviation Week* and *Space Technology*. The auditor would first determine if the industry statistics are comparable, for example, if the statistics are for the same or similar types of aircraft and if the types of items included in maintenance costs are similar. The auditor may then identify and test the internal controls over the production of these operating statistics.

### **Preciseness of the Expectation**

- .23 The auditor should develop an expectation of the account balance that is precise enough to provide the desired substantive assurance. When determining how precise the expectation should be, the auditor should determine the proper balance between effectiveness and efficiency. Any work to make the expectation more precise than the desired level of assurance is unnecessary.
- .24 If the audit objective cannot be achieved with the original expectation, the auditor may be able to perform additional procedures to make the expectation more precise. The preciseness of the expectation and changes in this preciseness are difficult to measure in quantifiable terms, unless the auditor uses regression



analysis in performing the analytical procedures. The auditor should consult with the audit sampling specialist before using regression analysis.

.25 Factors that influence the expectation's preciseness follow:

- **The identification and use of key factors when building the model based on the relationships identified by the auditor:** The expectation generally becomes more precise as additional key factors are identified.
- **The reliability of the data used to develop the expectation:** The expectation becomes more precise as the reliability of the data increases.
- **The degree of disaggregation of the data:** The expectation becomes more precise as the disaggregation of the data increases.

## **495 B – Example Procedures for Tests of Budget Information**

- .01 This section includes examples of procedures that auditors may perform in testing budget information for the statement of budgetary resources and reconciliation of net cost of operations to budget.
- .02 In addition, if budget controls are ineffective and quantitative provisions of budget-related laws and regulations are significant, the auditor generally should perform audit procedures sufficient to detect material misstatements in the types of budget information listed in FAM 460.04. Tolerable misstatement for use in determining sample sizes is discussed in FAM 460.

### **Testing Obligations and Expended Authority Transactions**

- .03 The following are examples of procedures that the auditor may use to test obligation and expended authority transactions for these misstatements.

#### **Validity, accuracy/valuation, and classification assertions:**

- a. Select obligations recorded as of the end of the audit period and expended authority transactions recorded during the audit period.
- b. Determine if each selected item is a valid obligation or expended authority transaction based on the criteria set forth in FAM 395 F.
- c. Determine if each selected item is recorded at the accurate amount (value).
- d. Determine if each selected item is properly classified in the appropriation or fund account (also by program and by object, if applicable), including the proper appropriation year.

#### **Completeness and cutoff assertions:**

- a. Select obligations and expended authority transactions recorded during the period between the balance sheet date and a date near the audit completion date.
- b. Examine open purchase orders, unpaid invoices, and contracts as of a date near the audit completion date.
- c. Select items representing payments by Treasury or cash disbursements by the entity during the audit period. Substantive detail test selections of expenses and additions to inventory, property, and prepaid accounts may be used for this purpose if the populations from which they are selected are complete.
- d. For each selection, determine whether the obligation or expended authority transaction is recorded in the proper period. If transactions are not recorded, or are recorded in the incorrect period, determine the effects of this misstatement on budget amounts, the evaluation of budget controls, and the risk of material misstatement.
- e. If the selected obligation or expended authority transaction relates to the audit period and is recorded in that period, determine if it is recorded at the proper amount and properly classified in the appropriation or fund account (also by program and by object, if applicable), including the proper appropriation year.

**Summarization assertion:**

- a. Test the footing of the detail of the obligation account balance recorded as of the end of the audit period and expended authority accounts recorded during the audit period.
  - b. Reconcile the total of these details to the recorded totals for obligation and expended authority accounts as of the end of the audit period. Audit software is often an effective tool for footing the transactions recorded in the accounts and for selecting items for testing.
- .04 The auditor generally should coordinate the audit procedures discussed above for testing expended authority transactions with the audit of other financial statement amounts. For example, if appropriate, the auditor may coordinate tests of accounts payable for completeness with the selection of subsequent obligations and expended authority transactions described above.

## Testing Outlay Transactions

- .05 The following are examples of procedures that the auditor may use to test outlay transactions. The auditor generally should coordinate these audit procedures with the audit of the other financial statement amounts, chiefly cash disbursements.

**Validity and classification assertions:**

- Select outlays recorded during the audit period. Determine if an invoice and a receiving report support each selected outlay. Determine the obligation that was liquidated by the outlay.
  - Examine the support for the obligation and determine if the invoice billed for goods or services is related to or properly “matches” the obligation and, in turn, the appropriation.
  - Obtain the accounting data for the matched obligation, including appropriation and year. Match these data to the type of services paid for by the selected outlay. Determine if the related appropriation authorizes payment for the services billed and paid.
- .06 The auditor also generally should test upward and downward adjustments of prior-year obligations. If any of these adjustments relate to closed accounts, the auditor generally should determine whether the adjustments comply with the requirements for closing appropriation accounts under 31 U.S.C. §§ 1551-1558.

## **495 C – Guidance for Interim Testing**

### **Misstatements in Interim Balances**

- .01 If the auditor detects unexpected misstatements when assessing the risks of material misstatement at an interim date, the auditor should evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified (AU-C 330.24). (See FAM 295 D for a discussion of factors in deciding whether to use interim substantive testing.) The auditor should determine the effects of misstatements by evaluating relevant factors, including
- the nature and cause of the misstatement;
  - the estimated effects on the overall line item/account balance;
  - whether the entity has subsequently corrected the misstatement; and
  - the impact of the misstatement on other parts of the audit.
- .02 The auditor should discuss financial statement misstatements with entity management. Based on the nature and cause of the misstatements detected, the auditor should determine, and obtain supporting evidence on, whether the misstatements are likely to occur in the remainder of the line items/account balances at the interim testing date and at the year's end. (See FAM 480.35 for a discussion of the need to project all misstatements unless evidence is highly persuasive that a misstatement is isolated and the audit director approves.<sup>1</sup>)

The auditor should request that entity management correct such misstatements in the population. Based on the following guidance, the auditor should use professional judgment to determine the extent to which interim testing can be relied upon, in conjunction with substantive procedures in the roll-forward period, to provide sufficient appropriate evidence on the year-end line item/account balance under the following circumstances:

- a. If the misstatements are not material when projected to the entire population (projected misstatements plus an allowance for further misstatements is less than tolerable misstatement) and are expected to be representative of the misstatements of the year-end balance, the auditor may rely upon the results of the interim testing.
- b. If the auditor has obtained highly persuasive evidence that the misstatements are isolated (generally by nature, cause, or extent), the auditor may be able to rely upon unaffected parts of the interim testing and apply procedures at year-end to test only those financial statement assertions associated with the misstatements.

For example, in interim testing of inventory, the auditor might determine that the misstatements concern only the valuation of inventory. Accordingly, the auditor may rely upon other parts of the interim testing, such as those for the

---

<sup>1</sup>The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate (AU-C 330.A74).

accuracy of the physical count and cutoff, and perform detail valuation testing and related procedures at year-end.

- c. If the misstatements are material or pervasive, the auditor should determine (1) whether to place any reliance on the interim testing, (2) the effect on the risk of material misstatement, and (3) the nature and extent of substantive procedures to be performed on the line item/account balance as of the balance sheet date.
- .03 For any misstatements found during interim testing, the auditor uses professional judgment to evaluate, in a manner appropriate for the circumstances, the effects on the year-end balance.

## Testing the Roll-Forward Period

- .04 Because the auditor reports on the financial statements as of year-end, not the interim test date, the auditor should perform further substantive procedures or substantive procedures combined with tests of controls (if the auditor concludes that substantive procedures alone would not be sufficient to cover the remaining period). The auditor should perform procedures to provide the auditor with a reasonable basis for extending the audit conclusions from the interim date to year-end. The auditor should perform substantive procedures of the roll-forward period activity to the year-end balance.

For example, after interim testing of the loans receivable balance as of June 30, the auditor may examine supporting documents for selected debits and credits to the balance during the roll-forward period of July 1 through September 30. The auditor may also apply analytical procedures to compare the amount of roll-forward activity, on a month-by-month basis, with expectations based on results for preceding months or similar periods of preceding years.

- .05 The auditor should determine the nature and extent of substantive procedures based on the assessment of risk of material misstatement and tolerable misstatement. In some instances, the auditor may determine that a specific risk of material misstatement warrants additional or different substantive procedures at year-end, such as cutoff tests. If risk of material misstatement is moderate or low, the auditor generally should determine whether the internal controls as of the interim testing date were in place and were operating effectively during the roll-forward period. The auditor may refer to the results of tests of financial reporting controls, which cover the entire year under audit for significant systems.
- .06 When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, the auditor should determine what additional evidence concerning the operation of the controls for the remaining period is necessary (AU-C 940.40). The additional evidence necessary to update the results of testing from an interim date to the entity's period-end depends on the following factors:
- The specific control tested prior to the as-of date, including the risks associated with the control, the nature of the control, and the results of those tests.
  - The sufficiency of the evidence of operating effectiveness obtained at an interim date.

- The length of the remaining period.
- The possibility that there have been any significant changes in internal control subsequent to the interim date.

## **Documentation**

- .07 The auditor should document
- line items/accounts and assertions to which interim testing is applied;
  - the basis for using interim testing;
  - audit procedures used to test interim balances and the roll-forward period (including tests of controls, findings, and conclusions);
  - effects of any misstatements found during interim testing and during roll-forward testing; and
  - conclusions on the line items as of and for the year.

## **495 D – Intentionally Left Blank**

## **495 E – Sampling**

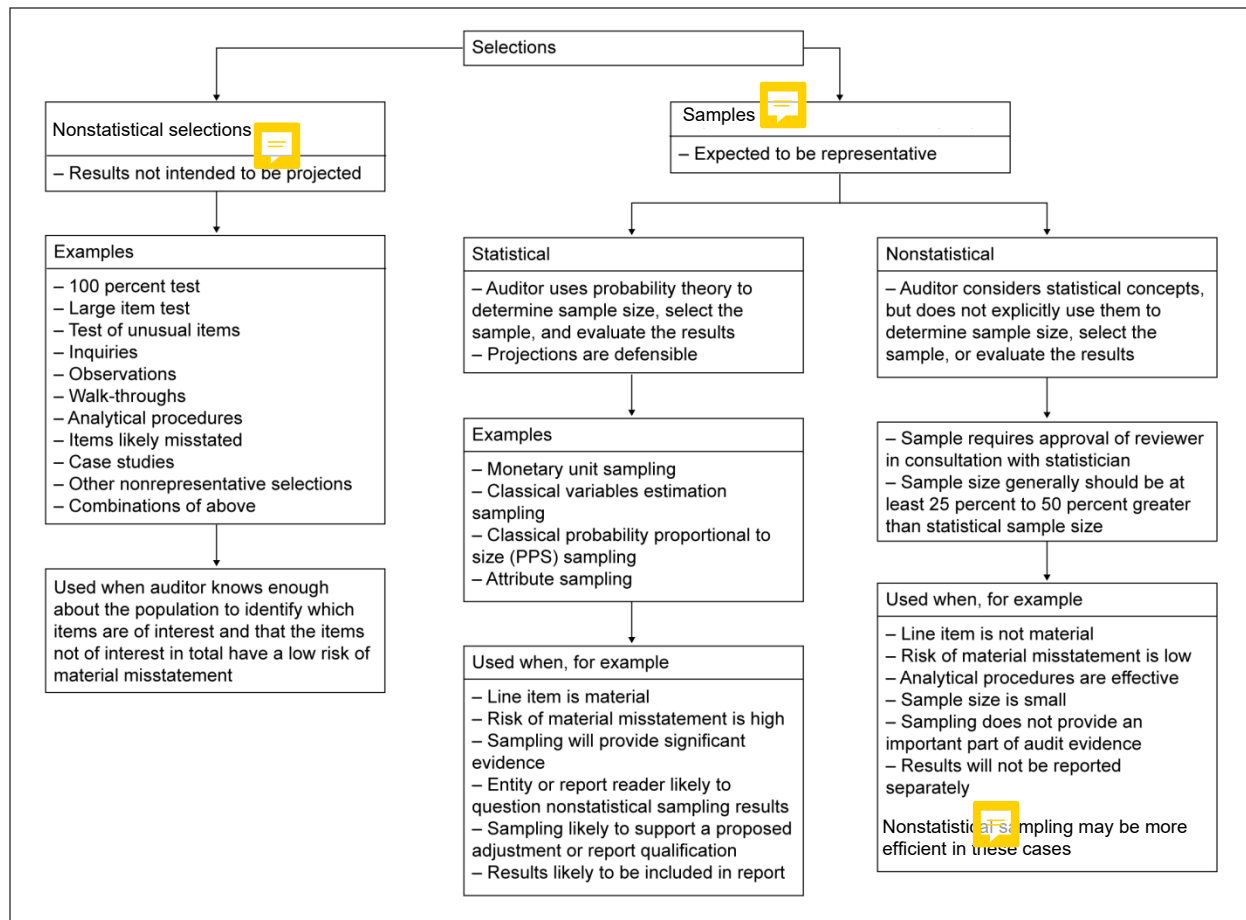
### **Sampling Flowcharts and Example Audit Documentation**

- .01 This section contains sampling flowcharts (FAM 495 E-2 through E-6) and example audit documentation for sampling (FAM 495 E-7 through E-19).
- .02 Flowchart 1 (FAM 495 E-2) assists the auditor in determining the selection method for substantive, internal control, and compliance tests. Selection methods are either nonrepresentative (nonsampling selections) or representative selections (samples—either statistical or nonstatistical).
- .03 Flowchart 2 (FAM 495 E-3) helps the auditor determine the type of sampling. The choices are (1) attribute sampling, (2) MUS, and (3) classical variables estimation sampling.

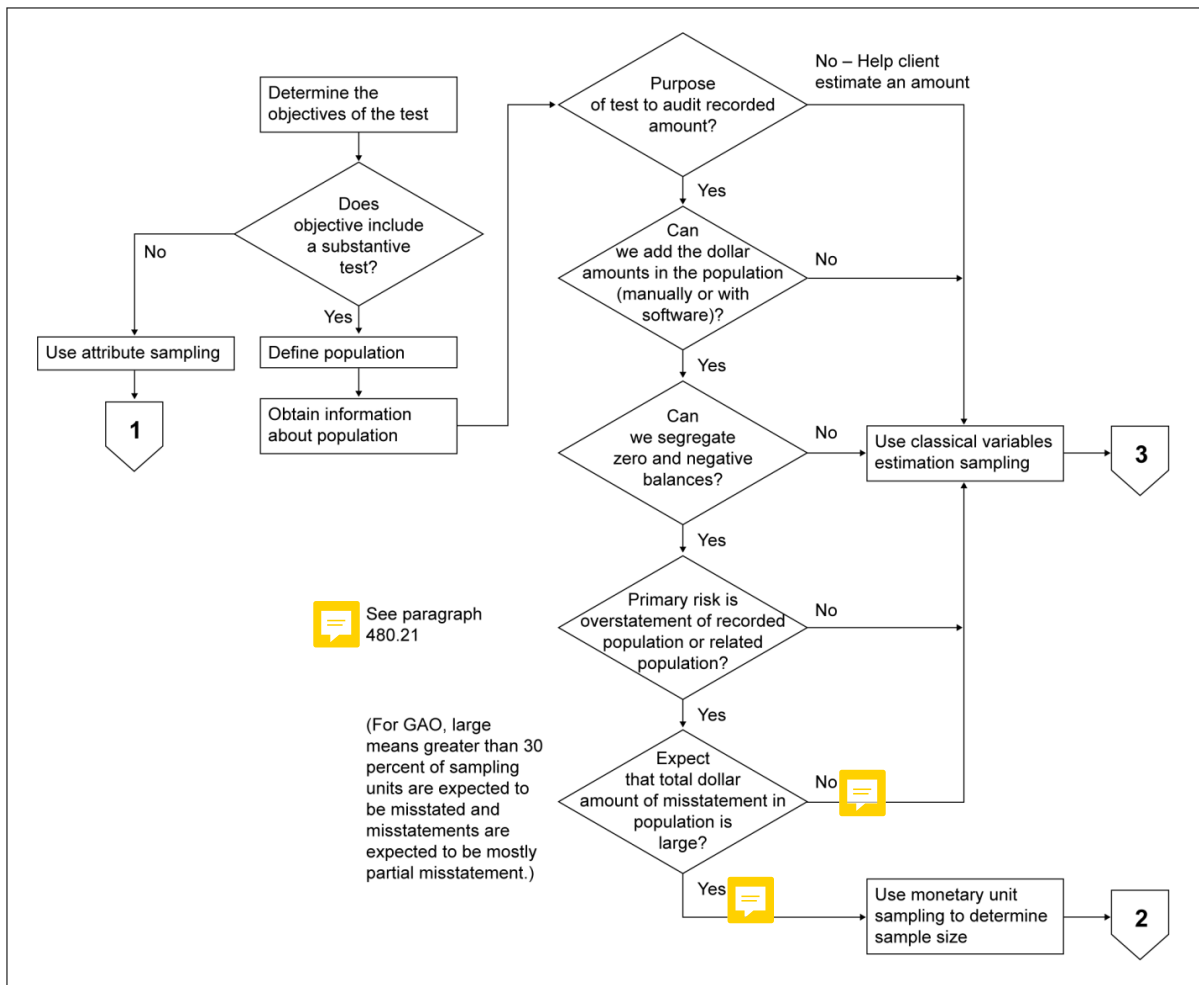
When testing for overstatement in the defined population and a large misstatement rate is expected, the auditor may use classical PPS sampling. See FAM 480.29 through .30 and FAM 480.39 for further information and consult the audit sampling specialist.
- .04 The remaining flowcharts are to assist the auditor in performing
  - attribute sampling at FAM 495 E-4 (flowchart 3),
  - MUS at FAM 495 E-5 (flowchart 4), and
  - classical variables estimation sampling at FAM 495 E-6 (flowchart 5).
- .05 Examples of audit documentation for sampling are provided for
  - attribute sampling at FAM 495 E-7 through E-10,
  - MUS at FAM 495 E-11 through E-15, and
  - classical variables estimation sampling at FAM 495 E-16 through E-19.



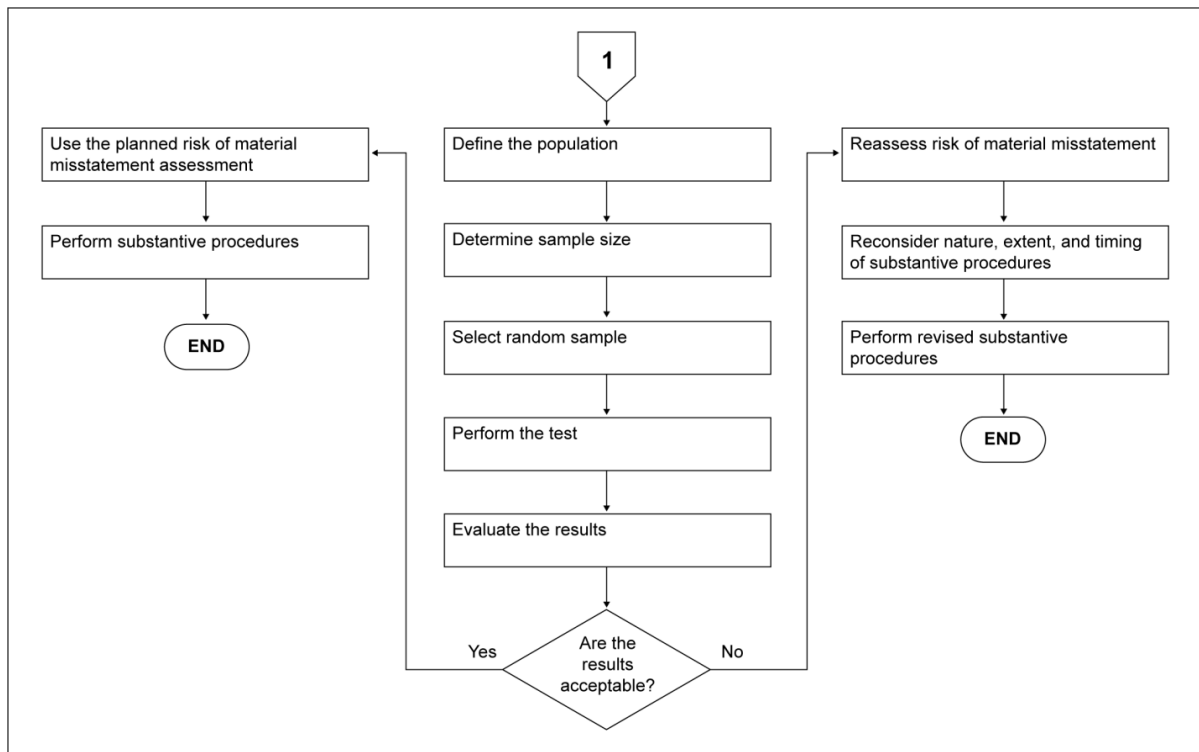
## Flowchart 1: Determining the Selection Method for Substantive, Internal Control, and Compliance Tests



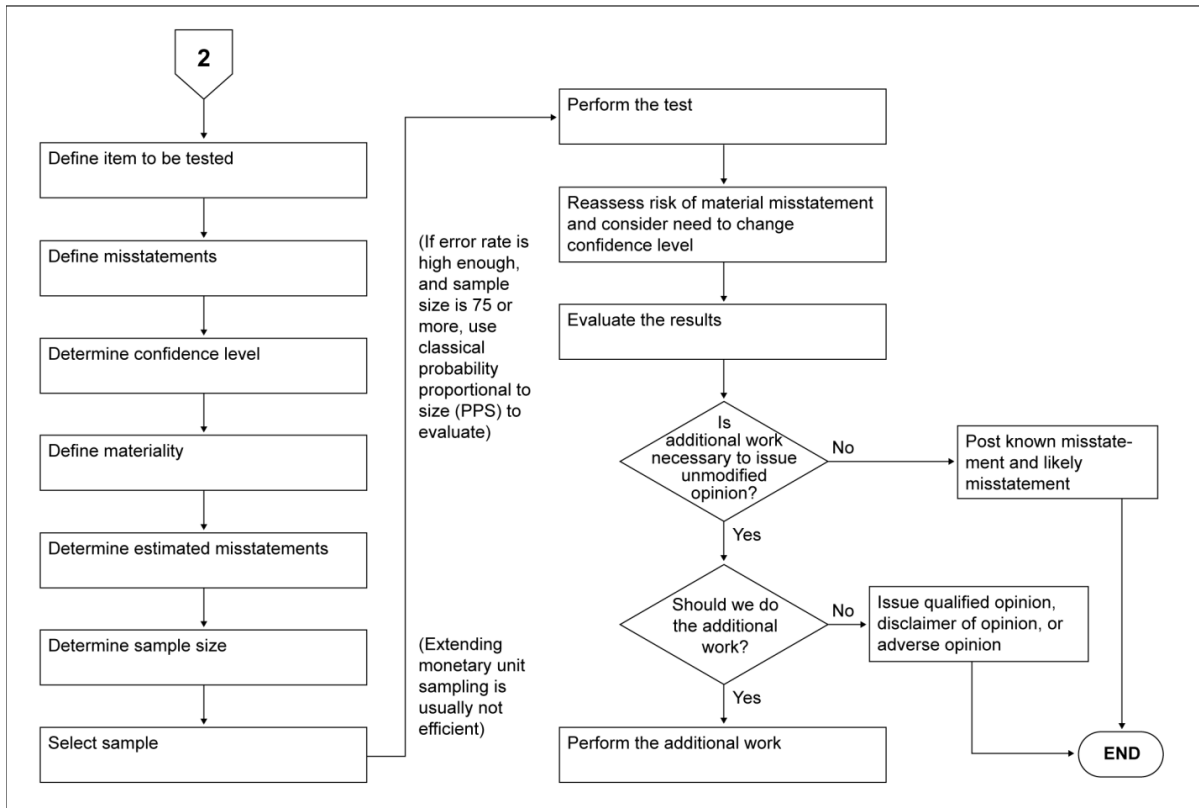
## Flowchart 2: Determining Which Type of Sampling to Use



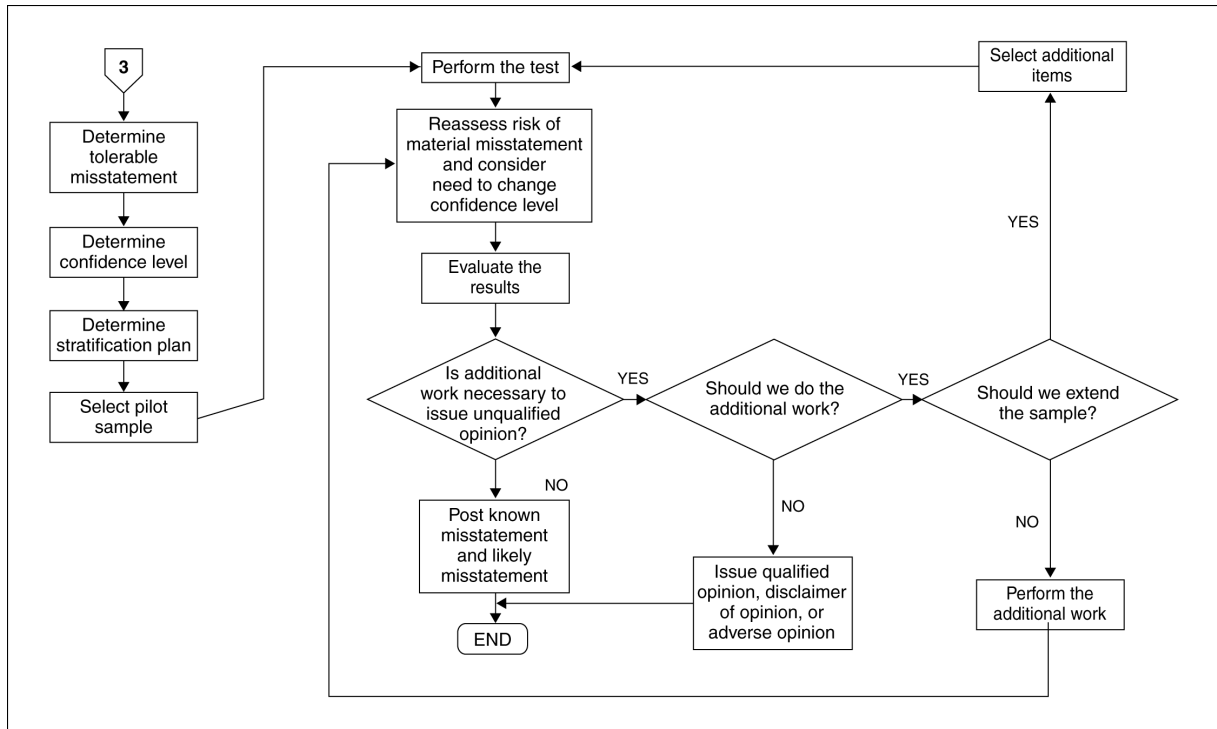
### Flowchart 3: Testing Using Attribute Sampling



## Flowchart 4: Testing Using Monetary Unit Sampling



## Flowchart 5: Testing Using Classical Variables Sampling



### **Example Audit Documentation for Attribute Sampling**

Entity: \_\_\_\_\_

Period Ended: \_\_\_\_\_

| <u>During Planning</u> |             | <u>At End of Test</u> |             |
|------------------------|-------------|-----------------------|-------------|
| <u>Initials</u>        | <u>Date</u> | <u>Initials</u>       | <u>Date</u> |
| Prepared by: _____     | _____       | _____                 | _____       |
| Reviewed by: _____     | _____       | _____                 | _____       |

#### **SECTION I Definition of Control Techniques and Sampling Method for Attribute Sampling**

Cycle: \_\_\_\_\_

Application: \_\_\_\_\_

Control activities (from SCE worksheets): \_\_\_\_\_

\_\_\_\_\_

Sampling Method: ☐ Random using IDEA/other audit software

Documentation reference to IDEA/other audit software output: \_\_\_\_\_

☐ Other – explain: \_\_\_\_\_

\_\_\_\_\_

## SECTION II Definition of Population and Attributes to Test for Attribute Sampling

Population is:

Population size: \_\_\_\_\_ units

Attributes to test:

Document(s) to examine:

When this period is less than the entire period under audit or where the population being tested is less than the population in the financial statements, describe briefly (and cross-reference to) procedures for obtaining satisfaction about the remainder of the population:

List steps needed to achieve satisfaction that the selection is from a population equivalent to the defined population:

### SECTION III Determination of Sample Size and Evaluation of Sample Results for Attribute Sampling

| Control activity number | Deviation definitions (each will constitute a deviation) <sup>a</sup> | Preliminary assessment of control risk (see SCEs)              |   |   |   |   |
|-------------------------|---|--|---|---|---|---|
|                         |   | Sample size (per Table I in FAM 450.08, IDEA, or other source) |   |   |   |   |
|                         |   | Acceptable number of deviations                                |   |   |   |   |
|                         |   | Number of deviations found                                     |   |   |   |   |
|                         |   | Is result acceptable? <sup>bc</sup>                            |   |   |   |   |
|                         |   | A  | B | C | D | E |
|                         |   |  |   |   |   |   |
|                         |   |  |   |   |   |   |
|                         |   |  |   |   |   |   |
|                         |   |  |   |   |   |   |
|                         |   |  |   |   |   |   |
|                         |   |  |   |   |   |   |

<sup>a</sup>Insert deviation definitions and data for columns A through C for each control technique before selection of sample.

<sup>b</sup>Results are acceptable if column D is less than column C. When results are unacceptable, complete section IV.

<sup>c</sup>If the attribute sample was selected through MUS as part of multipurpose testing and all items in the MUS sample are tested for attributes, then auditors should use IDEA's MUS evaluation module instead of FAM Table II to evaluate the results.

Method of testing for more than one control activity:

- ☐ Use largest sample size for all key controls (generally because same documents are tested)
- ☐ Use different sample sizes for different controls (using random numbers in order selected)



#### SECTION IV Explain Unacceptable Results and Other Control Deviations for Attribute Sampling

| Deviation | Possible Cause | Cycles, assertions, and accounts that could be affected | Further action taken | Conclusion / revised risk of material misstatement* |
|-----------|----------------|---|----------------------|---|
|           |                |   |                      |   |
|           |                |   |                      |   |
|           |                |   |                      |   |
|           |                |   |                      |   |
|           |                |   |                      |   |
|           |                |   |                      |   |
|           |                |   |                      |   |

#### SECTION V Overall Conclusions about Risk of Material Misstatement

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\*Where the preliminary assessment of the risk of material misstatement was low, the risk may be assessed as moderate if the number of deviations found does not exceed the acceptable number of deviations in Table II (FAM 450.08) for the same sample size.

### Example Audit Documentation for MUS

|  |                        |             |                       |             |
|--|------------------------|-------------|-----------------------|-------------|
| Entity:  |                        |             |                       |             |
| Period Ended:  |                        |             |                       |             |
|  | <u>During Planning</u> |             | <u>At End of Test</u> |             |
|  | <u>Initials</u>        | <u>Date</u> | <u>Initials</u>       | <u>Date</u> |
| Prepared by:   |                        |             |                       |             |
| Reviewed by:   |                        |             |                       |             |
| <br><b>SECTION I Define Objectives and Method of Testing for MUS</b> |                        |             |                       |             |
| Line Item:   |                        |             |                       |             |
| Assertion:   |                        |             |                       |             |
| Test:  |                        |             |                       |             |

## SECTION II Define Population for MUS

Population is:

Population size:

monetary units (dollars)

Logical unit (balance or transaction that  
includes the selected dollar:

Direction of test: Starting from (source):

Testing to (documents to be examined):

When this period is less than the entire period  
under audit or where the population being  
tested is less than the population in the  
financial statements, describe briefly (and  
cross-reference to) procedures performed to  
determine the remainder of the population  
does not contain a risk of material  
misstatement:

List steps needed to achieve satisfaction that  
the selection is from a population equivalent  
to the defined population:

Population analyzed (see FAM 480.01) by: ☐ Review of printout of population  
☐ Review of manual listing of population  
☐ IDEA / other audit software stratification  
☐ Other computer-assisted method – describe:

### SECTION III Determine Sample Size and Interval for MUS

- a. Total population (from Section II): \_\_\_\_\_
- b. Risk of material misstatement from the LIRA: \_\_\_\_\_
- c. Amount of substantive audit assurance required (from audit matrix): \_\_\_\_\_
- d. Substantive assurance from analytical procedures that relate to the assertion tested: \_\_\_\_\_
- e. Other substantive tests of detail that relate to the assertion: \_\_\_\_\_
- f. Minimum substantive audit assurance from detail tests: \_\_\_\_\_
- g. For MUS using IDEA / other audit software:
- 1. Confidence level: \_\_\_\_\_ %
  - 2. Materiality (generally tolerable error): \$ \_\_\_\_\_
  - 3. Expected misstatement amount: \$ \_\_\_\_\_
- h. Interval based on these factors is: \$ \_\_\_\_\_
- Random start or seed is: \_\_\_\_\_
- i. Sample size based on these factors is: \_\_\_\_\_
- Audit documentation reference to:
- ☐ Software output (IDEA / other audit software) \_\_\_\_\_
  - ☐ Manual computation \_\_\_\_\_

## SECTION IV Evaluation of Substantive Tests for MUS

(If many errors are found and the sample size is 75 or greater, the auditor generally should consult with the audit sampling specialist to evaluate and document as classical PPS.)

### Known Substantive Misstatements

| Misstatement number                  | (A)<br>Book amount | (B)<br>Audited amount | (C)<br>Misstatement amount (A-B) | Nature of Misstatement                             | Possible Cause                                     |
|--------------------------------------|--------------------|-----------------------|----------------------------------|--|--|
| Items greater than sampling interval |                    |                       |                                  |  |  |
| 1                                    | _____              | _____                 | _____                            | _____  | _____  |
| 2                                    | _____              | _____                 | _____                            | _____  | _____  |
| 3                                    | _____              | _____                 | _____                            | _____  | _____  |
| Total*                               | _____              | _____                 | _____                            |  |  |
| (D)                                  |                    |                       |                                  |  |  |
|                                      |                    |                       |                                  | Misstatement as a percentage of book amount* (C/A) | Should misstatement be projected? If not, explain: |
| Items less than sampling interval    |                    |                       |                                  |  |  |
| 1                                    | _____              | _____                 | _____                            | _____  | _____  |
| 2                                    | _____              | _____                 | _____                            | _____  | _____  |
| 3                                    | _____              | _____                 | _____                            | _____  | _____  |
| Total*                               |                    |                       |                                  | _____  |  |

\*Calculated amounts may be omitted if calculation done using IDEA.

Note 1: When sampling from a different population for understatement of a primary population (such as when sampling subsequent disbursements to test completeness of recorded accounts payable), in computing "misstatement as a percentage of book amount" the "book amount" is the subsequent disbursement (not the recorded payable). The audited amount is the amount that was either correctly accrued or not correctly accrued. For example, assume the auditor finds a \$10,000 subsequent disbursement that was omitted improperly from accounts payable as of the balance sheet date. The "book amount" is \$10,000 and the "audited amount" is zero, thus the "misstatement as a percentage of book amount" is 100 percent. The "book amount" is based on the source of selection, not necessarily what is recorded in the financial statements.

Note 2: If IDEA/other audit software selects an item twice and it is misstated, include the item twice in this listing.

### Compute projected misstatements

(Omit steps E through H if computed by IDEA)

- (E) Number of equivalent complete misstatements in sample from column D on previous page (excluding misstatements found in 100% examined items – see Note 1 on previous page: \_\_\_\_\_
- (F) Sampling interval \_\_\_\_\_
- (G) Projected misstatements (E x F) \_\_\_\_\_
- (H) Misstatements found in 100% examined items \_\_\_\_\_
- (I) Total projected misstatement (G + H) (or from IDEA output) \_\_\_\_\_
- (If from IDEA, document reference to IDEA output) \_\_\_\_\_

**Conclusion** Are we satisfied that book amount is free from material misstatement? ☐ Yes ☐ No ☐ Not enough evidence

If No or Not enough evidence, what will we do? Explain below:

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

### Example Audit Documentation for Classical Variables Estimation Sampling

Entity:

Period Ended:

During Planning

At End of Test

Initials

Date

Initials

Date

Prepared by:

Reviewed by:

## **SECTION I Definition Objectives and Method of Testing for Classical Variables Estimation Sampling**

Line Item:

Assertion:

Test:

Description of 100\$ examined items:

## SECTION II Define Population for Classical Variables Estimation Sampling

Population is:

Population size:

Dollars

Number of items

Direction of test: Starting from (source):

Testing to (documents to be examined):

When this period is less than the entire period under audit or where the population being tested is less than the population in the financial statements, describe briefly (and cross-reference to) procedures for obtaining satisfaction about the remainder of the population:

List steps needed to achieve satisfaction that the selection is from a population equivalent to the defined population:

Population analyzed by: ☐ Review of printout of population  
☐ Review of manual listing of population  
☐ IDEA / other audit software stratification  
☐ Other computer-assisted method – describe:



### SECTION III Determine Sample Size for Classical Variables Estimation Sampling

a. Confidence level \_\_\_\_\_ %

b. Tolerable misstatement \$ \_\_\_\_\_

c. Precision for total population \$ \_\_\_\_\_

d. Strata definitions:

|    | Stratum | From  | To    | Number of Items | Dollars |
|----|---------|-------|-------|-----------------|---------|
| 1  | _____   | _____ | _____ | _____           | _____   |
| 2  | _____   | _____ | _____ | _____           | _____   |
| 3  | _____   | _____ | _____ | _____           | _____   |
| 4  | _____   | _____ | _____ | _____           | _____   |
| 5  | _____   | _____ | _____ | _____           | _____   |
| 6  | _____   | _____ | _____ | _____           | _____   |
| 7  | _____   | _____ | _____ | _____           | _____   |
| 8  | _____   | _____ | _____ | _____           | _____   |
| 9  | _____   | _____ | _____ | _____           | _____   |
| 10 | _____   | _____ | _____ | _____           | _____   |

e. Sample size based on these factors is: \_\_\_\_\_

Audit documentation reference to:

☐ IDEA / other audit software \_\_\_\_\_

☐ Other calculation \_\_\_\_\_

☐ Pilot sample estimate \_\_\_\_\_

#### SECTION IV Evaluation of Substantive Tests for Classical Variables Estimation Sampling

a. Evaluation method – audit documentation reference to:

☐ IDEA / other audit software \_\_\_\_\_

☐ Other calculation \_\_\_\_\_

☐ Spreadsheet \_\_\_\_\_

b. Estimating technique

☐ Direct projection

☐ Difference estimation

☐ Separate ratio

☐ Combined ratio

☐ Combined regression

☐ Other \_\_\_\_\_

c. Point estimate \$ \_\_\_\_\_

Confidence interval

From \$ \_\_\_\_\_ To \$ \_\_\_\_\_ at \_\_\_\_\_ % confidence level

#### Conclusion

Are we satisfied that book amount is free from material misstatement? ☐ Yes ☐ No ☐ Not enough evidence

If No or Not enough evidence, what will we do? Explain below:

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

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# SECTION 500

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Reporting Phase

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## **510 – Overview of the Reporting Phase**

.01 Based on the work in the preceding phases, the auditor decides how to report on (as applicable)

- the financial statements taken as a whole;
- required supplementary information (RSI) (including management's discussion and analysis (MD&A)) and other information presented with the financial statements;
- the entity's internal control over financial reporting;
- the financial management systems' substantial compliance with the three Federal Financial Management Improvement Act of 1996 (FFMIA) requirements (for Chief Financial Officers (CFO) Act agencies); and
- the entity's compliance with applicable laws, regulations, contracts, and grant agreements.

The following sections provide guidance for making these determinations and formulating the report type and form. Guidance is also provided on other activities that the auditor should perform during the reporting phase (see Contents).

## **520 – Perform Overall Analytical Procedures**

### **Purposes of Overall Analytical Procedures**

- .01 As the audit nears completion, the auditor should design and perform overall analytical procedures, as discussed in the American Institute of Certified Public Accountants' (AICPA) Clarified Statements on Auditing Standards (AU-C) 520. The purposes of these procedures are
- to determine if an adequate understanding of all fluctuations from expectations and relationships in the financial statements has been obtained; or if not, to identify and resolve significant or unusual fluctuations from expectations that have not been identified and resolved in other audit procedures; and
  - to determine if other audit evidence is consistent with explanations for fluctuations from expectations documented during overall analytical procedures; and
  - to assist the auditor when forming an overall conclusion about whether the financial statements are consistent with the auditor's understanding of the entity (AU-C 520.06).
- .02 If overall analytical procedures indicate that an adequate understanding of relationships and fluctuations has not been obtained or if there are inconsistencies in audit evidence gathered from other audit procedures, the auditor should make further inquiries and perform sufficient testing to obtain an adequate understanding or to resolve the inconsistencies.
- .03 The auditor may perform overall analytical procedures in more detail than the financial statement level (supplemental analytical procedures, as discussed in FAM 475) and then use the results of these procedures to "roll up" into and support the overall analytical procedures at the financial statement level. For example, the auditor may perform overall analytical procedures at the account level and roll them up to the financial statement line item to which they belong.
- .04 The auditor may use analytical procedures to obtain complete or partial substantive assurance for certain accounts or to perform supplemental analytical procedures when detail tests are used exclusively to obtain substantive assurance. The auditor may use information obtained during these procedures as the basis for explanations of fluctuations for overall analytical procedures.
- .05 Audit efficiency and effectiveness may be gained if the same audit staff that conducted the detail tests on an account also conducts the supplemental analytical procedures by building on the knowledge obtained during detail testing.
- .06 The auditor generally should coordinate overall analytical procedures with the evaluation of the MD&A, including forming conclusions about the information in the MD&A. See FAM 280.05 for performing procedures over RSI.

### **Performance of Overall Analytical Procedures**

- .07 The auditor should achieve the purposes of overall analytical procedures described above by taking the following actions:

- a. **Assessing expectations:** The auditor should determine if expectations previously developed during preliminary analytical procedures in FAM 225.03 (a) are still appropriate or should be revised.
- b. **Comparing current-year amounts with expectations:** This information may be on a summarized level, such as the level of financial statements, or a more detailed level, as discussed in FAM 520.03.
- c. **Identifying significant or unusual fluctuations from expectations that have not already been identified and resolved:** The auditor should determine whether previously established parameters for determining whether a fluctuation is significant are still appropriate. Parameters are usually based on performance materiality. Unusual fluctuations include inappropriate accounting balances (such as debit balances in liability accounts), balances with either no current-year or no prior-year comparison, and decreases in property accounts that would normally occur only by disposition (instead of by misstatements) or inconsistencies with other relevant information obtained during the audit (AU-C 520.08c). Fluctuations identified are a matter of the auditor's professional judgment. The auditor should also evaluate the absence of expected fluctuations when identifying significant fluctuations (such as lower foreclosure rates on home loans despite higher default rates).
- d. **Understanding identified fluctuations from expectations:** The auditor should understand all significant fluctuations identified, obtain audit evidence corroborating the causes, and document the causes. The documentation may be a brief description with a reference to corroborating audit evidence. If the auditor does not understand the cause of a fluctuation or if the understanding is not consistent with the audit evidence, the auditor should perform procedures to obtain an understanding or to resolve any inconsistencies.
- e. **Evaluating the results of overall analytical procedures:** The auditor should evaluate these results to determine if the auditor obtained an adequate understanding of significant fluctuations from expectations and if the financial statements are consistent with the auditor's understanding of the entity. If the auditor identifies a previously unrecognized risk of material misstatement, the auditor should revise the auditor's assessment of the risks of material misstatement and modify the audit procedures accordingly (AU-C 520.A26).

## **530 – Reassess Materiality and Risks of Material Misstatement (AU-C 450.10)**

- .01 In the planning phase, the auditor determined materiality for the financial statements taken as a whole based on preliminary information. Based on this materiality, the auditor determined performance materiality and tolerable misstatement, which affected the extent of audit testing. Also in planning, the auditor assessed the risks of material misstatement by assertion. During the audit, the auditor may have revised these determinations and assessments if better information became available.
- .02 Before the end of the audit, prior to evaluating the effect of uncorrected misstatements, the auditor should reassess materiality for the financial statements taken as a whole to confirm whether it remains appropriate in the context of the entity's actual (final) financial statements (AU-C 450.10). If the reassessment of materiality results in a lower amount (or amounts), then the auditor should reconsider performance materiality and the appropriateness of the nature, timing, and extent of the further audit procedures in order to obtain sufficient appropriate audit evidence on which to base the audit opinion.
- .03 Before the conclusion of the audit, the auditor should also reassess, based on the audit procedures performed and the audit evidence obtained, whether the assessments of the risks of material misstatement at the relevant assertion level remain appropriate (AU-C 330.27). The auditor should determine whether the overall audit strategy and audit plan need to be revised
- if the aggregate of misstatements accumulated during the audit approaches materiality for the financial statements taken as a whole (determined in accordance with AU-C 320) (AU-C 450.06.b) or
  - if the nature of the identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that when aggregated with misstatements accumulated during the audit, could be material (AU-C 450.06a).

See FAM 540 for evaluating accumulated misstatements.

In addition, if material weaknesses or other significant deficiencies are identified, the auditor should consider their implications on this risk assessment.

- .04 The auditor should update the fraud risk evaluation throughout the audit because evidence gathered later in the audit could change or support an earlier judgment about fraud risks. For example, the auditor may identify discrepancies in the accounting records or conflicting or missing evidence.
- .05 The auditor should evaluate, at or near the end of the audit, whether the accumulated results of auditing procedures affect the assessment of the risks of material misstatement due to fraud made earlier in the audit or indicate a previously unrecognized risk of material misstatement due to fraud. In this case, the auditor should evaluate the need for additional or different audit procedures. If not already performed when forming an overall conclusion, the analytical procedures relating to revenue, should be performed through the end of the reporting period (AU-C 240.34). The auditor should



- perform overall analytical procedures related to revenue, if revenue is (or is expected to be) material;
  - evaluate whether overall analytical or other substantive procedures indicate a previously unrecognized fraud risk;
  - evaluate whether responses to inquiries during the audit have been vague, implausible, or inconsistent with other evidence; and
  - evaluate other evidence gathered during the audit.
- .06 Based on these reassessments, the auditor should determine whether the nature, extent, and timing of substantive audit procedures were sufficient, such as the appropriateness of sample sizes for detail tests and the limit for investigation of differences during substantive analytical procedures. When the auditor has questions regarding the adequacy of work performed or sufficiency of audit evidence, the auditor should consult with the reviewer to determine the need for additional procedures.
- .07 When the auditor determines whether an opinion can be expressed on the financial statements, the auditor should evaluate any limitations on the nature, extent, or timing of work performed. Additional guidance on scope limitations and their impact is provided in FAM 580.03 through .08. Also see FAM 545 for further evaluation of misstatements (uncorrected and undetected).

## **540 – Evaluate Effects of Misstatements on Financial Statements and Auditor’s Reports**

- .01 The auditor might detect misstatements during substantive tests or other procedures. The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial (AU-C 450.05), and evaluate misstatements individually and in the aggregate in both quantitative and qualitative terms. Based on the evaluation of all misstatements, the auditor should determine whether the overall audit strategy and audit plan need to be revised (AU-C 450.06), as discussed in FAM 530. See FAM 595 C for additional details. Additionally, the auditor should determine the effects of accumulated misstatements on the financial statements and the auditor’s conclusions and reports.
- .02 As discussed in AU-C 330, the auditor should not assume that an instance of fraud or error is an isolated occurrence and therefore should evaluate how the detection of the misstatement affects the assessed risks of material misstatement, including (1) the related nature, extent, and timing of substantive audit procedures and (2) the audit evidence of the operating effectiveness of relevant controls, including the entity’s risk assessment and monitoring process. In addition to evaluating the effects of misstatements on the financial statements, the auditor should evaluate the effects of misstatements on the following:
- a. The auditor’s conclusions on internal control (see FAM 580.43 through .72).  
*The auditor should determine whether the misstatements indicate control deficiencies that had not been previously identified, whether the assessment of the controls and the risk of material misstatement at the relevant assertion level remain appropriate, whether audit procedures are appropriate in light of any revisions to the risks of material misstatement, and whether the categorization of control deficiencies for reporting purposes is appropriate (whether they are material weaknesses or other significant deficiencies).*
  - b. The consideration of the risks of material misstatement due to fraud (see FAM 540.18 through .21).  
*The auditor should determine whether to change the risk of material misstatement due to fraud determined during planning, based on the accumulated results of audit procedures.*
  - c. The auditor’s evaluation of the financial management systems’ substantial compliance with the three FFMIA requirements, if applicable (see FAM 580.74 through .78).  
*The auditor should evaluate the effects of misstatements on the auditor’s conclusions with respect to the financial management systems’ substantial compliance with the three FFMIA requirements.*
  - d. The entity’s compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements (see FAM 580.79 through .86).  
*The auditor should evaluate the effects of misstatements on the auditor’s conclusions with respect to the entity’s compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.*

- e. Budget formulation and execution.

*The auditor should evaluate the effects the misstatements have on budget-related matters for purposes of reporting budget control deficiencies, reporting on the statement of budgetary resources and reconciliation of net cost to budget note disclosure, and reporting on compliance with applicable budget-related provisions of laws and regulations.*

- f. Other reports.

*The auditor should evaluate whether the misstatements include effects of related control deficiencies in FAM 580 affect other reports prepared by the entity that are (1) used for management decision-making or (2) distributed outside the entity.*

- .03 FAM 475 (substantive analytical procedures) and FAM 480 (substantive detail tests) discuss the evaluation of individual misstatements from a quantitative standpoint.

Note: The auditor should accumulate all misstatements above clearly trivial (even those adjustments identified by the auditor and already corrected by management during the audit). If the auditor judges an individual misstatement to be material, the auditor generally should not offset other misstatements against it.<sup>1</sup> Following that guidance, the auditor should quantify the effects of the misstatement. (See AU-C 450.11.)

To assist in evaluating the effects of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, the auditor generally should use the following categories to classify each misstatement as either of the following:

- **Factual misstatements:** The amount of misstatement about which there is no doubt.
- **Judgmental misstatements:** Differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate.
- **Projected misstatements:** The auditor's best estimate of the amount of the misstatements in populations, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn. (AU-C 450.A3)

- .04 The auditor should also accumulate all corrected misstatements throughout the audit period. The auditor should evaluate the corrected misstatements and consider whether the misstatements indicate (1) an increased risk in internal

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<sup>1</sup>For example, if assets have been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on net position is completely offset by an equivalent overstatement of liabilities. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate. (See AU-C 450.A21.)

control over financial reporting, (2) an increased risk of material misstatement, or (3) the potential existence of further undetected misstatements.

## **Accumulate Misstatements**

- .05 To evaluate the aggregate effects of misstatements on the financial statements, the auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial (AU-C 450.05), and generally should classify each misstatement as factual, judgmental, or projected on a Schedule of Uncorrected Misstatements (before discussion with management), an example of which is illustrated at FAM 595 C, Example 1. (Note: This includes any misstatements that the entity brings to the auditor's attention that have not been corrected in the financial statements.)

The auditor should quantify and evaluate misstatements under both the rollover and iron curtain approaches, including consideration of the effects on the current-period financial statements of any misstatements related to prior periods on the relevant classes of transactions, accounts, balances, or disclosures and the financial statements taken as a whole (AU-C 450.11.b). Subsequently, the auditor generally should propose an adjusting entry when either approach results in quantifying a misstatement that is above clearly trivial, after considering all relevant quantitative and qualitative factors. One approach quantifies a misstatement based on the amount of the misstatement originating in the current-year statement of net cost (i.e., rollover approach). Thus, this approach ignores the effects of correcting the portion of the current-year balance sheet misstatement that originated in prior years. Misstatements originating in the current year, as quantified in the rollover approach, consist of 1) misstatements arising in the current year (for example, an understatement of current year payroll expenses identified in the testing of current year payroll expenses) and 2) misstatements arising in prior periods that affect the current year (for example, an understatement of current year non-payroll expenses from a cutoff error in the prior year). The other approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement's year of origination (i.e., iron curtain approach). (See additional discussion and examples in Securities and Exchange Commission Staff Accounting Bulletin No. 108.) The rollover and iron curtain approaches quantify the effects of misstatements arising in the current year identically; however, the approaches quantify misstatements arising in prior periods differently (also, see FAM 540.16).

For example, the auditor identifies an expense cutoff error in which \$200 of expenses related to the following year were recorded in the current year, thereby overstating other liabilities by \$200 at the end of the current year. In addition, a similar cutoff error existed at the end of the prior year, in which \$300 of expenses related to the current year were included in the prior year. Under the rollover approach, the auditor would only consider the effect of the misstatement on the current year Statement of Net Cost. Therefore, in this example, the auditor would quantify (1) the effect of the \$200 overstatement of expenses arising in the current year, offset by (2) the effect of the reversal of the \$300 understatement of expenses included in the prior year that should have been incurred in the current year. Under the iron curtain approach, the auditor instead quantifies the misstatement based on correcting the misstatement in the balance sheet at the end of the current year. Therefore, in this example, the auditor would quantify the

effect of only the \$200 misstatement to other liabilities as of the end of the current year. See FAM 595 C for an illustration of these approaches.

- .06 The financial statements usually include various accounting estimates made by management, such as the recoverability of assets (through allowances for doubtful accounts receivable or loans) and liabilities for loan guarantees. The auditor should evaluate whether the estimates are either reasonable or are misstated. If the recorded amount falls outside a range of amounts that the auditor determines is reasonable, the auditor generally should include at least the difference between the recorded amount and the closest end of the auditor's range as a judgmental misstatement in the Schedule of Uncorrected Misstatements (AU-C 540.18 and .A122).

## Review Misstatements with Management

- .07 After accumulating and summarizing the misstatements on a Schedule of Uncorrected Misstatements (an example of which is at FAM 595 C, Example 1) (AU-C 450.12b) the auditor **should**, on a timely basis, take the following actions:
- Communicate all these misstatements accumulated during the audit with appropriate entity management. This includes communicating factual, judgmental, and projected misstatements (AU-C 450.07).
  - Request that entity management to adjust the entity's financial statements and underlying records to correct all misstatements accumulated during the audit (AU-C 450.07).
  - For misstatements that are material either individually or when aggregated with other misstatements, request that entity management examine the classes of transactions, account balances, or disclosures to identify and quantify the entity's own amount of related misstatements. This may also help determine the cause of the misstatements. The auditor should then test management's procedures and the amount of the proposed adjustment to determine the reasonableness of the amount. The auditor should perform additional audit procedures if needed (AU-C 450.07 and .08). Entity management may establish valuation allowances for projected misstatements, net of factual misstatements (since the projected misstatement represents the best estimate of the total correction needed).<sup>2</sup>  
  
For judgmental misstatements involving differences in estimates, the auditor may share the assumptions and methods used to develop the estimate with management so that management can revise its estimate.
  - Communicate all misstatements accumulated during the audit with those charged with governance, including the following information:
    - The effect that the misstatements, individually or in the aggregate, may have on the opinion in the auditor's report. The auditor's communication should identify material uncorrected misstatements individually. The auditor should request that uncorrected misstatements be corrected.

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<sup>2</sup>Generally, entities resist booking projected misstatements citing no supporting transactions. However, the amount can be booked through a general journal entry and reversed the following year.

- The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances, or disclosures and the financial statements taken as a whole (AU-C 260.13).
  - Material, corrected misstatements that were brought to the attention of management as a result of audit procedures (AU-C 260.14).
- .08 In presenting the misstatements to management, the auditor generally should remind management that AU-C 580 requires the entity to indicate in the management representation letter that the uncorrected misstatements aggregated by the auditor, both individually and in the aggregate, are not material to the financial statements taken as a whole. AU-C 580 also requires that a summary of the uncorrected misstatements be attached to the representation letter. Attaching this summary is further discussed in FAM 1001 and presented in the example representation letter at FAM 1001 A. Thus, management may consider some of the same factors presented in FAM 540.09 through .17.

### **Consider the Effects of Uncorrected Misstatements on the Financial Statements**

- .09 If management does not correct the financial statements, the auditor should obtain an understanding of management's reasons for not making the corrections and whether the uncorrected misstatements are considered material. The auditor should take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement (AU-C 450.09). The auditor should update the Schedule of Uncorrected Misstatements to reflect the uncorrected misstatements after discussions with management (FAM 595 C, Example 2) (AU-C 450.12b).
- .10 If entity management declines to record adjustments for any identified misstatements, the auditor should determine the effects of these uncorrected misstatements, individually and in the aggregate, on the financial statements, including the effect on individual line items (even if the amount is netted in the line item). The auditor should also consider the effect on the financial statement audit opinion in both quantitative and qualitative terms.
- .11 If management disagrees with the auditor's judgmental and projected misstatements, and if the disagreement involves amounts that are material, the auditor should again request that entity management perform procedures, such as reviewing all or substantially all of the items in the relevant population, to determine its own estimated amount of the misstatement and provide more assurance as to the auditor's estimate, if the entity has not yet done so. If the entity determines its own estimate of the misstatement, the auditor should test management's procedures and conclusions and determine whether additional audit procedures are necessary.

If management refuses to perform the necessary investigation, the audit director may decide not to expend additional time and audit resources to resolve the disagreement because, for example, additional testing is unlikely to provide different conclusions.

- If the auditor believes that the auditor's estimate is sufficiently accurate, the auditor should express a qualified or adverse opinion, depending on the

materiality and pervasiveness of the item to the financial statements taken as a whole.

- If the auditor believes that the auditor's estimate is not sufficiently accurate, the auditor should express a qualified or disclaimer of opinion for a scope limitation, depending on the materiality and pervasiveness of the item to the financial statements taken as a whole.

The auditor should document an overall evaluation, including decisions reached, of any management disagreement with the misstatements.

- .12 If the total of uncorrected misstatements is material, the auditor should modify the opinion on the financial statements (see FAM 580.09). Deciding how to modify the opinion based on the materiality of total uncorrected misstatements involves significant auditor's judgment. The decision and the basis for it should be documented. The audit director should be involved in the decision and review the documentation related to it. Also, the reviewer should review and approve the documentation of the decision.

Misstatements, either individually or in the aggregate, are material if, in light of surrounding circumstances, it is probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the correction of the items. The concept of materiality includes both quantitative and qualitative considerations, as further discussed in FAM 230 and FAM 545.

### **Qualitative Considerations**

- .13 The auditor should also evaluate appropriate qualitative aspects when determining the effect of uncorrected misstatements on the auditor's report. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are quantitatively lower than materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which a misstatement has the following attributes:
- a. Is considered sensitive to financial statement users, that is, the Congress, the public, influential special interest groups, and interested foreign governments.
  - b. Offsets other misstatements in the aggregate but is individually significant.
  - c. Has a significant effect on the RSI (including MD&A presented by management), and other information.
  - d. Affects compliance with laws and regulations.
  - e. Affects compliance with contracts or grant agreements.
  - f. Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements.
  - g. Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability).

- h. Represents an omission of information not specifically required by the applicable financial reporting framework but that in the professional judgment of the auditor is important to the users' understanding of the financial position, financial performance, or cash flows of the entity.
- i. Affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in an MD&A that may reasonably be expected to influence the decisions of the users of the financial statements).
- j. Is currently immaterial but is likely to have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.
- k. Is too costly to correct. It may not be cost beneficial for the entity to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management.
- l. Represents a risk that possible additional undetected misstatements would affect the auditor's evaluation.
- m. Changes a loss into income or vice versa.
- n. Heightens the sensitivity of the circumstances surrounding the misstatement (for example, the implications of misstatements involving fraud and possible instances of noncompliance with laws, regulations, or contracts conflicts of interest).
- o. Relates to the definitive character of the misstatement (for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty).
- p. Indicates the motivation of management (for example, [i] an indication of a possible pattern of bias by management when developing and accumulating accounting estimates, [ii] a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process, or [iii] an intentional decision not to follow the applicable financial reporting framework).
- q. Involves proprietary or sensitive information, such as protected health information, federal taxpayer information, or classified national security information.
- r. Affects financial markets, the U.S. economy, or political decisions, such as controversial pending legislation or an upcoming election.
- s. Indicates selective correction by management of certain misstatements brought to its attention during the audit (for example, correcting misstatements with the effect of increasing reported earnings but not correcting misstatements that have the effect of decreasing reported earnings).

These circumstances are only examples—not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances



such as these does not necessarily lead to a conclusion that a misstatement is material. See AU-C 450.A23 for further examples.

- .14 When determining whether uncorrected misstatements are material, either individually or in the aggregate, to the financial statements, the auditor should consider the size and nature of the misstatements, both in relation to particular classes of transactions, account balances, or disclosures in the financial statements and in relation to the financial statements taken as a whole, and the particular circumstances of their occurrence (AU-C 450.11a).

If the auditor provides assurance on any combining statements and supplemental schedules in relation to the financial statements taken as a whole, the auditor should determine whether these statements and schedules are materially misstated due to uncorrected misstatements.

- .15 Although there is a point at which total uncorrected misstatements would generally be considered material, there is no single amount that can be used for the auditor's decision to modify the opinion. Instead, the auditor should also follow a process that considers various factors in reaching this decision. See FAM 545, if applicable.

### **Treatment of Misstatements That Arose in Prior Periods but Were Detected in the Current Period**

- .16 If, during the audit of the current period, the auditor detects a misstatement that arose in a prior period but was not previously detected, the auditor should include the misstatement in the Schedule of Uncorrected Misstatements and bring it to management's attention. The auditor should determine if the misstatement, together with other uncorrected misstatements, is material to the prior-period and/or current-period financial statements. The auditor should gather sufficient information to evaluate the cumulative effects, as well as the current-year change, related to the misstatement on beginning and ending balances, such as those for balance sheet accounts, as well as the related impact on the current year's activity, such as that shown on the statement of net cost (AU-C 450.11.b). Also, see FAM 580.91 regarding financial statement restatements.

If the misstatement is material, the auditor should consult with the reviewer to determine the effect on the current-period statements and the auditor's report. Also, see FAM 580.91 regarding financial statement restatements.

### **Evaluate Whether Identified Misstatements Indicate Fraud**

- .17 The auditor should evaluate whether identified misstatements might indicate fraud. If such an indication exists, the auditor should evaluate the implications of the misstatement with regard to other aspects of the audit, particularly the auditor's evaluation of materiality, management and employee integrity, and the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence (AU-C 240.35). If, preliminarily, the auditor believes that a misstatement is or might be the result of fraud, the auditor should consult with the audit director and the reviewer, who should determine whether to

seek assistance from the Special Investigator Unit or the Office of the General Counsel (OGC). If performing the audit under contract, the auditor should consult with the Assistant Inspector General for Audit, or the GAO managing director who has responsibility for the audit. If, on the basis of evidence obtained, the auditor believes that an instance of fraud (or significant abuse) has occurred or is likely to have occurred, the auditor should

- consult with the Special Investigator Unit and OGC (or if performing the audit under contract, the auditor should consult with the Assistant Inspector General for Audit, or the GAO managing director),
- include relevant information in the audit report unless the instance is clearly inconsequential, and
- determine that those charged with governance are adequately informed.

If the auditor has identified or suspects a fraud, the auditor should determine whether the auditor has a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances (AU-C 240.42). In some circumstances, the auditor may be required by law or regulation to report directly to outside parties about fraud (or significant abuse). However, the auditor should limit public reporting to matters that would not compromise any related investigative or legal proceedings (see *Government Auditing Standards* (2011), paragraphs 4.27).

- .18 If a misstatement is or might be the result of fraud and the effect is not material to the financial statements, the auditor should evaluate the implications, especially those regarding the organizational position and responsibilities of the individual involved. If the matter involves a relatively low-level employee who is not responsible for significant activities (for example, a misappropriation from a small petty cash fund by a nonmanagement employee), the auditor may conclude that the matter has little significance to the audit. However, if the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is, or may be, the result of fraud and that management (in particular, senior management) is involved, the auditor should reevaluate the assessment of the risks of material misstatement due to fraud and its resulting effect on the nature, timing, and extent of audit procedures to respond to the assessed risks (AU-C 240.36). The auditor should evaluate whether (1) the misstatement is qualitatively material and (2) it might indicate a more pervasive problem.

Accordingly, the auditor should reevaluate the assessment of fraud risk, as well as the risk of material misstatement, and the resulting effects on the nature, extent, and timing of substantive procedures. The auditor should also consider whether circumstances or conditions indicate possible collusion involving employees, management, or third parties when reconsidering the reliability of evidence previously obtained (AU-C 240.36). Regardless of the level of the employee involved, the auditor should report the potential fraud to at least the next level of management. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with them about fraud perpetrated by lower-level employees.

- .19 If a misstatement is or might be the result of fraud and either the effect could be material or the auditor is unable to determine whether the effect is material, the auditor should
- attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred and its effect on the financial statements and the related audit report;
  - evaluate the implications for other aspects of the audit, including reevaluating the assessment of risks and the resulting effects on testing, as described in the preceding paragraph (AU-C 240.20);
  - discuss the matter and the approach for further investigation with at least the next higher level of entity management and with senior management and those charged with governance; and
  - determine whether to advise entity management to consult with its legal counsel.
- .20 The auditor should discuss in the audit report any fraud that causes a material misstatement of the financial statements. In addition, depending on circumstances, fraud (material or immaterial) could affect the reports on the financial statements; internal control over financial reporting; and compliance with applicable laws, regulations, contracts, and grant agreements and the quality of management representations. The auditor should consult with the audit director and the reviewer and should report the matter to those charged with governance.

## **545 – Audit Exposure (Further Evaluation of Audit Risk)**

- .01 At the beginning of the audit, performance materiality (which, as defined, is one or more amounts) was set to reduce to an appropriately low level the probability that the aggregate of uncorrected and potential undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole (AU-C 320.09). Before the conclusion of the audit, the auditor should consider any potential further misstatement to the financial statements taken as a whole by accumulating the total of uncorrected misstatements plus an overall allowance for undetected misstatements. If the aggregate of misstatements accumulated during the audit approaches materiality, a greater than acceptably low level of risk may exist that possible undetected misstatements, when taken with the aggregate of uncorrected misstatements accumulated during the audit, could exceed materiality (AU-C 450.A5). It is important to evaluate the potential further misstatement amount in relation to materiality for the financial statements as a whole (see FAM 230.05) and the relative importance of the misstated items to readers of the financial statements (qualitative and mitigating aspects). Therefore, the auditor should determine whether its audit exposure (audit exposure is the combination of detected misstatements, possible undetected misstatements, and qualitative aspects) is material to the financial statements.

### **Evaluation**

- .02 The auditor may or may not detect misstatements during substantive tests or other procedures performed during the audit (see FAM 540). However, the auditor should evaluate the risk of potential undetected misstatement, which is due to the imprecision of audit procedures, as discussed in FAM 230.12. This risk includes such things as (1) unaudited amounts/accounts that were considered to be individually immaterial and were not tested on that basis (untested amounts); (2) the sampling precision associated with statistical samples selected for substantive tests of financial statement balances (or, if no statistical samples are selected, including an allowance equal to performance materiality);<sup>1</sup> and (3) an allowance for the imprecision of substantive analytical procedures on which the auditor placed complete reliance. For example, all untested amounts are considered to be 100 percent overstated for this evaluation.

Totaling the amounts from these aspects with any uncorrected misstatements (FAM 540) provides a conservative quantitative estimate of the potential amount of misstatement to the financial statements as a whole, which affects audit exposure. For example, if the aggregate uncorrected misstatement is \$10 million and the allowance for imprecision of audit procedures is probably no more than \$5 million, the auditor should determine whether the total of \$15 million materially misstates the financial statements taken as a whole. The auditor should consult the reviewer in considering these issues.

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<sup>1</sup>An audit sampling specialist may perform or be consulted on all statistical calculations.

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Reporting Phase

545 – Audit Exposure (Further Evaluation of Audit Risk)

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- .03 The auditor may also consider any other aspects that may increase the risk of potential undetected misstatements and also consider any mitigating factors that may lower the risk of misstatement.
- .04 See FAM 545 A for a template that the auditor can use to conduct this analysis.

## **545 A – Further Evaluation of Audit Risk Template**

- .01 This template is a tool that the auditor can use to conduct the analysis described in FAM 545. The template consists of three sections: (1) Conclusions, (2) Consideration of Quantitative Factors, and (3) Consideration of Other Factors.

### **Consideration of Quantitative Factors**

#### **Overall**

- .02 Amounts that do not affect the materiality (benchmark) will be entered to column C for each financial statement in the tables below.
- a. Untested amounts and limits related to analytical tests upon which we placed 100 percent substantive reliance (see FAM 475.06) will be entered at absolute value (simple addition with no +/- signs).
  - b. Uncorrected misstatements that do not affect the benchmark will first be netted for each line item, and then the amount for all the line items will be accumulated at absolute value and the total entered to column C.
  - c. Sampling precision associated with statistical samples selected to test balances that do not affect the benchmark will be statistically combined with the assistance of the audit sampling specialist, and the result entered to column C. For any financial statement on which the benchmark does not appear, all amounts will be entered to column C. Hence in such cases, column D will not be needed, and “N/A” can be entered in each row. Amounts related to balances that do affect the benchmark will be entered in column D. In these cases, untested amounts, limits related to analytical tests upon which we placed 100 percent substantive reliance, and uncorrected misstatements will all be added or netted, as appropriate, to determine their actual effect on the benchmark and the results entered in column D. Combined sampling precision calculations related to balances that do affect the benchmark will be done the same way as for those balances that do not affect the benchmark (above), except that they will be entered in column D. So on any financial statement that includes the benchmark, and also reports a mixture of balances that do, and do not, affect the benchmark (and were subject to statistical sampling), two separate sample combination calculations will be needed—one for column C and one for column D. To illustrate some of these principles:
    - If the designated materiality benchmark is total assets, only the balance sheet will use column D at all because total assets does not appear on any other financial statement. On the balance sheet itself, the net exposure amount (debits less credits) to assets will appear in column D because it affects total assets. However, the amount of exposure to liabilities will be calculated separately at absolute value (rather than net value) and entered in column C because it does not affect total assets.
    - If the designated materiality benchmark is net position, the balance sheet and the statement of changes in net position will both only utilize column D because both statements include Net Position, and all of their line items affect it. Hence, in both cases, column C will not be used, and “N/A” can

be entered in each row. On all other financial statements, net position does not appear, and hence, the reverse will be true: Column D will be N/A, and only column C will be used. Because both assets and liabilities affect net position, the amount of exposure to each will be netted as described above and entered in column D for untested amounts, analytical limits, and uncorrected misstatements to arrive at the amount to the benchmark.

- .03 Use of Column C. Calculate the net uncorrected misstatements for each individual line item, as indicated above, and enter the result where directed. For all other amount elements, calculate the absolute value (eliminate +/- signs and add them up) of all individual amounts, and enter the result where directed. For example, if you have a \$50 untested liability, and a \$20 untested asset, you enter \$70 on the untested amounts line. Similarly, if you have a total reliance analytical procedures limit of \$30 related to one liability line item, and a \$60 dollar total reliance on analytical procedures limit related to another liability line item, you enter \$90 as the related amount. Because it is absolute value, debit/credit, asset/liability, and cost/revenue distinctions are irrelevant; remove the +/- signs and add them up. Combined sampling precision calculations would be done by the FMA sampling specialist. Auditors will need to identify situations where a financial statement includes both balances that do, and do not, affect the materiality benchmark. If both types of line items conditions exist and both were subject to statistical sampling, separate sample combination calculations would become necessary for each, so that the results can be split between columns C and D.
- .04 Use of Column D. Calculate the net affect (debits less credits) of each factor on the materiality benchmark, as described above, and enter the result. The question of what affects the benchmark depends on what benchmark is selected. For example, assume that the selected materiality benchmark on the balance sheet is total assets, and you have four untested asset amounts totaling \$50, and two allowances (contra-assets) totaling \$40—you net the two against each other, and enter \$10 on the untested amounts line as the potential undetected misstatement. Combined sampling precision calculations would be done the same, except that auditors will need to identify whether there are tests of balances that do, and do not, affect the materiality benchmark. If multiple line items were subject to statistical sampling, separate sample combination calculations would become necessary for each, so that the results can be split between columns C and D.
- .05 Do not separately calculate an exposure amount for financial statement line items, such as subtotals and totals, cumulative results of operations, and net position, as the amount of exposure related to these is shown elsewhere.
- .06 On the statement of budgetary resources (SBR), audit exposure will be calculated separately for each of the section of the SBR. Within each of the five sections, the results of all statistical samples selected will be statistically combined with the assistance of the audit sampling specialist.

### **Evaluation of Uncorrected Misstatements**

- .07 For each line item of each financial statement, calculate the net effect (debits less credits) of uncorrected misstatements, if any. Include only the misstatements

from nonstatistical selections or other nonstatistical tests (factual and judgmental). The estimated effect of the outcome of statistical tests will be included in the sampling precision calculations, below.

- .08 For those uncorrected misstatements that do not affect the materiality benchmark, calculate the absolute value of the amounts calculated in No. 1, above for each financial statement (i.e., once you have calculated the net effect on each line item, remove the +/- signs for the totals and add them up). Enter the result in the space indicated, column C for each financial statement.
- .09 For those uncorrected misstatements that do affect the materiality benchmark, calculate the net effect upon the materiality benchmark of all uncorrected misstatements (net the debits and the credits). Enter the result to the appropriate space in column D for each financial statement.

## **Evaluation of the Potential Undetected Misstatement**

### **Untested Amounts**

- .10 For untested amounts related to line items that do not affect the materiality benchmark, calculate the absolute value of the untested amounts, and enter the result to the appropriate space in column C for each financial statement.
- .11 For untested amounts related to line items that do affect the materiality benchmark, calculate the absolute value affect upon the materiality benchmark, and enter the result to the appropriate space in column D for each financial statement.

### **Sampling Precision - Monetary Unit Samples (MUS) and Non-MUS Samples**

- .12 For statistical sample(s) selected to test line items that do not affect the materiality benchmark, calculate and enter the combined sampling precision for each financial statement in the space provided, column C.
- .13 For statistical samples selected to test line items that do affect the materiality benchmark, calculate and enter the combined sampling precision for each financial statement in the space provided, column D. Assess this amount to the financial statement as a whole qualitatively.
- .14 If no statistical sampling was performed, enter the performance materiality in column D.

### **Analytical Procedures upon Which Complete Substantive Reliance Was Placed**

- .15 If we have identified a sound, reasonable, defensible basis upon which to estimate the ending balance of a line item, the auditor can consider complete (sole) reliance on an analytical procedure as an option for obtaining substantive assurance. However, this option is only available IF such a basis can be identified. If not, the balance will either need to be substantively tested through alternate means, or treated as an untested amount. FAM 475.06 provides guidance for establishing the limit in any case where the auditor elects to completely rely upon an analytical test for substantive assurance (i.e., there are no other tests of the balance during the same period such as sampling at an interim point, confirmations, reconciliations, or other analytical tests. If there were



- any other substantive tests, reliance is only partial), and defines the term “limit” in this context.
- .16 Identify analytical procedures upon which complete substantive reliance was placed, if any.
- .17 For each financial statement, identify any analytical procedures in which (a) the limit set was not exceeded by the observed differences between the expected and actual outcome, and (b) the differences identified were either not investigated, explained, and supported, or were only partially explained and supported (Do not include limits related to differences that were adequately explained/supported.) Examples:
- Example (a): We projected a final balance of \$1 million, and set a limit of \$200,000. The reported balance was actually \$900,000. Since the difference between the reported balance and our projected balance (\$100,000) is within the limit we set (\$200,000), we did not investigate. The amount in this case would be \$100,000, which is the difference we did not investigate between the reported balance (\$900,000) and the projected balance (\$1 million).
  - Example (b): We set the limit at \$50,000, the projected balance is \$900,000, and the reported balance is \$1,100,000. The difference between the reported balance (\$1,100,000) and our projected balance (\$900,000) is \$200,000, which exceeds our limit (\$50,000) so we investigated, but without success. We would propose an audit adjustment \$150,000, which is the extent to which the unexplained difference exceeds the limit. If the agency does accept and post the audit adjustment, the potential undetected misstatement would be \$50,000, which is the remaining portion of the unexplained difference we did not investigate and they did not correct. If the agency does not accept and post the proposed audit adjustment, audit amount would be \$200,000. Of this total, \$50,000 would be treated as a potential undetected misstatement due to complete reliance on a substantive analytical procedure, and \$150,000 (the rejected adjustment) would be treated as an uncorrected misstatement.
  - Example (c): The same facts as (a), above, except that we elect to investigate even though it's not necessary in the circumstances, and we obtain a reasonable, supported explanation. In this case, there would be no further amount to consider.
- .18 For limits related to any such analytical procedures affecting line items that do not affect the materiality benchmark, calculate the absolute value of all limits identified under (2), above, for each financial statement, and enter the result in the space indicated in column C.
- .19 For any such analytical procedures affecting line items that do affect the materiality benchmark, calculate the net effect of all limits identified under (2), above, for each financial statement, and enter the result in the space indicated in column D.
- .20 For consideration of the implications of any analytical procedures upon which we placed only partial substantive reliance, see Section 3, Consideration of Other Factors.

## Conclusions

### Purpose

To determine if our audit exposure (audit exposure is the combination of detected misstatements, possible undetected misstatements, and qualitative aspects) is material for our financial statement audit.

### Approach

We analyzed quantitative and qualitative factors potentially affecting our audit risk. The calculated measurable quantitative amounts for each financial statement (**Section II**) represents the total value of (1) the net amount of correcting audit adjustments that were not accepted and booked by XYZ agency, (2) amounts that were considered to be individually immaterial and were not tested on that basis (untested amounts), (3) the sampling precision associated with statistical samples selected for the purposes of performing substantive tests of financial statement balances (or, if no statistical samples selected including an allowance equal to performance materiality), (4) an amount for when no sampling has occurred, and (5) an allowance for the imprecision of substantive analytical procedures on which we placed total reliance. Our analysis was designed to provide a conservative estimate of the risk represented by these conditions, and therefore used conservative assumptions. For example, all untested amounts were considered to be 100% overstated. All statistical calculations were performed by or in consultation with an Audit Sampling Specialist.

We also considered whether other factors were relevant and potentially significant to our evaluation of audit risk. This includes factors that may affect risk, but whose actual dollar effect cannot be measured with any degree of precision (nonmeasurable quantitative factors). We also considered any mitigating factors that may lower the risk. These are documented in **Section III**.

### Materiality Benchmark(s)

Complete as per instructions. Example: We determined that the materiality benchmark was total gross costs because, based upon our judgment, we concluded that it is the most significant element of XXX's financial statements to users (FAM 230.08). During the planning phase of the audit, we used XXX's reported \$300 million in total gross costs for fiscal year 2015 to compute our performance materiality and tolerable misstatement thresholds. As XXX's actual total program costs of \$315 million for fiscal year 2016 exceeded the prior year amount used in the planning phase calculations, we believe that the performance materiality and tolerable misstatement thresholds used are adequate. Additionally, we assessed the adequacy of our determination to apply the materiality benchmark to each financial statement given the effect of identified misstatements on the various financial statements and line items; we determined that the application of the benchmark was valid.

### Sources

As indexed in Sections II and III.

### Conclusions

Based on considerations of both the quantitative and qualitative aspects of the audit exposure in this analysis, including the effect of amounts not directly affecting the materiality benchmark, we believe that the audit exposure is immaterial.

| BALANCE SHEET   |                      |  |   |
|---|----------------------|--|---|
| A   | B                    | C  | D   |
|   |                      | <b>Estimated Amounts</b>   |   |
|   |                      | Absolute Value<br>Effect of Factors<br>Not Directly<br>Affecting the<br>Materiality<br>Benchmark | Net Effect of Factors<br>Directly Affecting the<br>Materiality<br>Benchmark, Upon<br>the Materiality<br>Benchmark |
| <b>Risk of Material Misstatement (Quantitative)</b>   | <b>Doc.<br/>Ref.</b> |  |   |
| Factual Uncorrected Misstatements: <sup>1</sup>   |                      | \$0  | \$0   |
| Judgmental Uncorrected Misstatements:   |                      | 0  | 0   |
| <b>Subtotal: Factual and Judgmental Uncorrected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Estimate of Potential Undetected Misstatements:</b>  |                      |  |   |
| Untested Amounts  |                      | 0  | 0   |
| Combined Sampling Precision; Non-MUS Sample(s)  |                      | 0  | 0   |
| Combined Sampling Precision; MUS Sample(s)  |                      | 0  | 0   |
| <b>[Include Performance Materiality amount if no sampling was performed (and therefore, no global upper error limit amount was included in the 2 rows above)]</b> |                      | 0  | 0   |
| Limits Related to Analytical Procedures Relied Upon as the Only Substantive Test (Complete Reliance)  |                      | 0  | 0   |
| Other <sup>2</sup>  |                      | 0  | 0   |
| <b>Subtotal: Estimated Quantitatively Measurable Undetected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Total Estimated Quantitatively Measurable Misstatements</b>  |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Materiality Benchmark (\$ amount and benchmark used)</b>   |                      | <b>[Add \$ amount of benchmark used here]</b>  | <b>[Describe benchmark used (total assets, total cost, etc.)]</b>   |
| <b>Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark</b>   |                      | <b>0.0%</b>  | <b>0.0%</b>   |
| <b>[Add auditor's note regarding the auditor's assessment of the percentage.]</b>   |                      |  |   |

| STATEMENT OF NET COST   |                      |  |   |
|---|----------------------|--|---|
| A   | B                    | C  | D   |
|   |                      | <b>Estimated Amounts</b>   |   |
|   |                      | Absolute Value<br>Effect of Factors<br>Not Directly<br>Affecting the<br>Materiality<br>Benchmark | Net Effect of Factors<br>Directly Affecting the<br>Materiality<br>Benchmark, Upon<br>the Materiality<br>Benchmark |
| <b>Risk of Material Misstatement (Quantitative)</b>   | <b>Doc.<br/>Ref.</b> |  |   |
| Factual Uncorrected Misstatements: <sup>1</sup>   |                      | \$0  | \$0   |
| Judgmental Uncorrected Misstatements:   |                      | 0  | 0   |
| <b>Subtotal: Factual and Judgmental Uncorrected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Estimate of Potential Undetected Misstatements:</b>  |                      |  |   |
| Untested Amounts  |                      | 0  | 0   |
| Combined Sampling Precision; Non-MUS Sample(s)  |                      | 0  | 0   |
| Combined Sampling Precision; MUS Sample(s)  |                      | 0  | 0   |
| <b>[Include Performance Materiality amount if no sampling was performed (and therefore, no global upper error limit amount was included in the 2 rows above)]</b> |                      | 0  | 0   |
| Limits Related to Analytical Procedures Relied Upon as the Only Substantive Test (Complete Reliance)  |                      | 0  | 0   |
| Other <sup>2</sup>  |                      | 0  | 0   |
| <b>Subtotal: Estimated Quantitatively Measurable Undetected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Total Estimated Quantitatively Measurable Misstatements</b>  |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Materiality Benchmark (\$ amount and benchmark used)</b>   |                      | <b>[Add \$ amount of benchmark used here]</b>  | <b>[Describe benchmark used (total assets, total cost, etc.)]</b>   |
| <b>Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark</b>   |                      | <b>0.0%</b>  | <b>0.0%</b>   |
| <b>[Add auditor's note regarding the auditor's assessment of the percentage.]</b>   |                      |  |   |

| STATEMENT OF CHANGES IN NET POSITION  |                      |  |   |
|---|----------------------|--|---|
| A   | B                    | C  | D   |
|   |                      | <b>Estimated Amounts</b>   |   |
|   |                      | Absolute Value<br>Effect of Factors<br>Not Directly<br>Affecting the<br>Materiality<br>Benchmark | Net Effect of Factors<br>Directly Affecting the<br>Materiality<br>Benchmark, Upon<br>the Materiality<br>Benchmark |
| <b>Risk of Material Misstatement (Quantitative)</b>   | <b>Doc.<br/>Ref.</b> |  |   |
| Factual Uncorrected Misstatements: <sup>1</sup>   |                      | \$0  | \$0   |
| Judgmental Uncorrected Misstatements:   |                      | 0  | 0   |
| <b>Subtotal: Factual and Judgmental Uncorrected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Estimate of Potential Undetected Misstatements:</b>  |                      |  |   |
| Untested Amounts  |                      | 0  | 0   |
| Combined Sampling Precision; Non-MUS Sample(s)  |                      | 0  | 0   |
| Combined Sampling Precision; MUS Sample(s)  |                      | 0  | 0   |
| <b>[Include Performance Materiality amount if no sampling was performed (and therefore, no global upper error limit amount was included in the 2 rows above)]</b> |                      | 0  | 0   |
| Limits Related to Analytical Procedures Relied Upon as the Only Substantive Test (Complete Reliance)  |                      | 0  | 0   |
| Other <sup>2</sup>  |                      | 0  | 0   |
| <b>Subtotal: Estimated Quantitatively Measurable Undetected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Total Estimated Quantitatively Measurable Misstatements</b>  |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Materiality Benchmark (\$ amount and benchmark used)</b>   |                      | <b>[Add \$ amount of benchmark used here]</b>  | <b>[Describe benchmark used (total assets, total cost, etc.)]</b>   |
| <b>Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark</b>   |                      | <b>0.0%</b>  | <b>0.0%</b>   |
| <b>[Add auditor's note regarding the auditor's assessment of the percentage.]</b>   |                      |  |   |

| STATEMENT OF BUDGETARY RESOURCES – TOTAL BUDGETARY RESOURCES (SOURCES)  |                      |  |   |
|---|----------------------|--|---|
| A   | B                    | C  | D   |
|   |                      | <b>Estimated Amounts</b>   |   |
|   |                      | Absolute Value<br>Effect of Factors<br>Not Directly<br>Affecting the<br>Materiality<br>Benchmark | Net Effect of Factors<br>Directly Affecting the<br>Materiality<br>Benchmark, Upon<br>the Materiality<br>Benchmark |
| <b>Risk of Material Misstatement (Quantitative)</b>   | <b>Doc.<br/>Ref.</b> |  |   |
| Factual Uncorrected Misstatements: <sup>1</sup>   |                      | \$0  | \$0   |
| Judgmental Uncorrected Misstatements:   |                      | 0  | 0   |
| <b>Subtotal: Factual and Judgmental Uncorrected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Estimate of Potential Undetected Misstatements:</b>  |                      |  |   |
| Untested Amounts  |                      | 0  | 0   |
| Combined Sampling Precision; Non-MUS Sample(s)  |                      | 0  | 0   |
| Combined Sampling Precision; MUS Sample(s)  |                      | 0  | 0   |
| <b>[Include Performance Materiality amount if no sampling was performed (and therefore, no global upper error limit amount was included in the 2 rows above)]</b> |                      | 0  | 0   |
| Limits Related to Analytical Procedures Relied Upon as the Only Substantive Test (Complete Reliance)  |                      | 0  | 0   |
| Other <sup>2</sup>  |                      | 0  | 0   |
| <b>Subtotal: Estimated Quantitatively Measurable Undetected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Total Estimated Quantitatively Measurable Misstatements</b>  |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Materiality Benchmark (\$ amount and benchmark used)</b>   |                      | <b>[Add \$ amount of benchmark used here]</b>  | <b>[Describe benchmark used (total assets, total cost, etc.)]</b>   |
| <b>Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark</b>   |                      | <b>0.0%</b>  | <b>0.0%</b>   |
| <b>[Add auditor's note regarding the auditor's assessment of the percentage.]</b>   |                      |  |   |

| STATEMENT OF BUDGETARY RESOURCES – STATUS OF BUDGETARY RESOURCES  |                      |  |   |
|---|----------------------|--|---|
| A   | B                    | C  | D   |
|   |                      | <b>Estimated Amounts</b>   |   |
|   |                      | Absolute Value<br>Effect of Factors<br>Not Directly<br>Affecting the<br>Materiality<br>Benchmark | Net Effect of Factors<br>Directly Affecting the<br>Materiality<br>Benchmark, Upon<br>the Materiality<br>Benchmark |
| <b>Risk of Material Misstatement (Quantitative)</b>   | <b>Doc.<br/>Ref.</b> |  |   |
| Factual Uncorrected Misstatements: <sup>1</sup>   |                      | \$0  | \$0   |
| Judgmental Uncorrected Misstatements:   |                      | 0  | 0   |
| <b>Subtotal: Factual and Judgmental Uncorrected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Estimate of Potential Undetected Misstatements:</b>  |                      |  |   |
| Untested Amounts  |                      | 0  | 0   |
| Combined Sampling Precision; Non-MUS Sample(s)  |                      | 0  | 0   |
| Combined Sampling Precision; MUS Sample(s)  |                      | 0  | 0   |
| <b>[Include Performance Materiality amount if no sampling was performed (and therefore, no global upper error limit amount was included in the 2 rows above)]</b> |                      | 0  | 0   |
| Limits Related to Analytical Procedures Relied Upon as the Only Substantive Test (Complete Reliance)  |                      | 0  | 0   |
| Other <sup>2</sup>  |                      | 0  | 0   |
| <b>Subtotal: Estimated Quantitatively Measurable Undetected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Total Estimated Quantitatively Measurable Misstatements</b>  |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Materiality Benchmark (\$ amount and benchmark used)</b>   |                      | <b>[Add \$ amount of benchmark used here]</b>  | <b>[Describe benchmark used (total assets, total cost, etc.)]</b>   |
| <b>Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark</b>   |                      | <b>0.0%</b>  | <b>0.0%</b>   |
| <b>[Add auditor's note regarding the auditor's assessment of the percentage.]</b>   |                      |  |   |

| STATEMENT OF BUDGETARY RESOURCES – CHANGES IN OBLIGATIONS   |                      |  |   |
|---|----------------------|--|---|
| A   | B                    | C  | D   |
|   |                      | <b>Estimated Amounts</b>   |   |
|   |                      | Absolute Value<br>Effect of Factors<br>Not Directly<br>Affecting the<br>Materiality<br>Benchmark | Net Effect of Factors<br>Directly Affecting the<br>Materiality<br>Benchmark, Upon<br>the Materiality<br>Benchmark |
| <b>Risk of Material Misstatement (Quantitative)</b>   | <b>Doc.<br/>Ref.</b> |  |   |
| Factual Uncorrected Misstatements: <sup>1</sup>   |                      | \$0  | \$0   |
| Judgmental Uncorrected Misstatements:   |                      | 0  | 0   |
| <b>Subtotal: Factual and Judgmental Uncorrected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Estimate of Potential Undetected Misstatements:</b>  |                      |  |   |
| Untested Amounts  |                      | 0  | 0   |
| Combined Sampling Precision; Non-MUS Sample(s)  |                      | 0  | 0   |
| Combined Sampling Precision; MUS Sample(s)  |                      | 0  | 0   |
| <b>[Include Performance Materiality amount if no sampling was performed (and therefore, no global upper error limit amount was included in the 2 rows above)]</b> |                      | 0  | 0   |
| Limits Related to Analytical Procedures Relied Upon as the Only Substantive Test (Complete Reliance)  |                      | 0  | 0   |
| Other <sup>2</sup>  |                      | 0  | 0   |
| <b>Subtotal: Estimated Quantitatively Measurable Undetected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Total Estimated Quantitatively Measurable Misstatements</b>  |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Materiality Benchmark (\$ amount and benchmark used)</b>   |                      | <b>[Add \$ amount of benchmark used here]</b>  | <b>[Describe benchmark used (total assets, total cost, etc.)]</b>   |
| <b>Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark</b>   |                      | <b>0.0%</b>  | <b>0.0%</b>   |
| <b>[Add auditor's note regarding the auditor's assessment of the percentage.]</b>   |                      |  |   |



| STATEMENT OF BUDGETARY RESOURCES – BUDGET AUTHORITY AND OUTLAYS   |                      |  |   |
|---|----------------------|--|---|
| A   | B                    | C  | D   |
|   |                      | Estimated Amounts  |   |
|   |                      | Absolute Value<br>Effect of Factors<br>Not Directly<br>Affecting the<br>Materiality<br>Benchmark | Net Effect of Factors<br>Directly Affecting the<br>Materiality<br>Benchmark, Upon<br>the Materiality<br>Benchmark |
| <b>Risk of Material Misstatement (Quantitative)</b>   | <b>Doc.<br/>Ref.</b> |  |   |
| Factual Uncorrected Misstatements: <sup>1</sup>   |                      | \$0  | \$0   |
| Judgmental Uncorrected Misstatements:   |                      | 0  | 0   |
| <b>Subtotal: Factual and Judgmental Uncorrected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Estimate of Potential Undetected Misstatements:</b>  |                      |  |   |
| Untested Amounts  |                      | 0  | 0   |
| Combined Sampling Precision; Non-MUS Sample(s)  |                      | 0  | 0   |
| Combined Sampling Precision; MUS Sample(s)  |                      | 0  | 0   |
| <b>[Include Performance Materiality amount if no sampling was performed (and therefore, no global upper error limit amount was included in the 2 rows above)]</b> |                      | 0  | 0   |
| Limits Related to Analytical Procedures Relied Upon as the Only Substantive Test (Complete Reliance)  |                      | 0  | 0   |
| Other <sup>2</sup>  |                      | 0  | 0   |
| <b>Subtotal: Estimated Quantitatively Measurable Undetected Misstatements</b>   |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Total Estimated Quantitatively Measurable Misstatements</b>  |                      | <b>\$0</b>   | <b>\$0</b>  |
| <b>Materiality Benchmark (\$ amount and benchmark used)</b>   |                      | <b>[Add \$ amount of benchmark used here]</b>  | <b>[Describe benchmark used (total assets, total cost, etc.)]</b>   |
| <b>Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark</b>   |                      | <b>0.0%</b>  | <b>0.0%</b>   |
| <b>[Add auditor's note regarding the auditor's assessment of the percentage.]</b>   |                      |  |   |

| STATEMENT OF BUDGETARY RESOURCES – AGENCY OUTLAYS, NET  |              |  |   |
|---|--------------|--|---|
| A   | B            | C  | D   |
| Risk of Material Misstatement (Quantitative)  | Doc.<br>Ref. | Estimated Amounts  |   |
|   |              | Absolute Value<br>Effect of Factors<br>Not Directly<br>Affecting the<br>Materiality<br>Benchmark | Net Effect of Factors<br>Directly Affecting the<br>Materiality<br>Benchmark, Upon<br>the Materiality<br>Benchmark |
| Factual Uncorrected Misstatements: <sup>1</sup>   |              | \$0  | \$0   |
| Judgmental Uncorrected Misstatements:   |              | 0  | 0   |
| <b>Subtotal: Factual and Judgmental Uncorrected Misstatements</b>   |              | <b>\$0</b>   | <b>\$0</b>  |
| <b>Estimate of Potential Undetected Misstatements:</b>  |              |  |   |
| Untested Amounts  |              | 0  | 0   |
| Combined Sampling Precision; Non-MUS Sample(s)  |              | 0  | 0   |
| Combined Sampling Precision; MUS Sample(s)  |              | 0  | 0   |
| <b>[Include Performance Materiality amount if no sampling was performed (and therefore, no global upper error limit amount was included in the 2 rows above)]</b> |              | 0  | 0   |
| Limits Related to Analytical Procedures Relied Upon as the Only Substantive Test (Complete Reliance)  |              | 0  | 0   |
| Other <sup>2</sup>  |              | 0  | 0   |
| <b>Subtotal: Estimated Quantitatively Measurable Undetected Misstatements</b>   |              | <b>\$0</b>   | <b>\$0</b>  |
| <b>Total Estimated Quantitatively Measurable Misstatements</b>  |              | <b>\$0</b>   | <b>\$0</b>  |
| <b>Materiality Benchmark (\$ amount and benchmark used)</b>   |              | <b>[Add \$ amount of benchmark used here]</b>  | <b>[Describe benchmark used (total assets, total cost, etc.)]</b>   |
| <b>Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark</b>   |              | <b>0.0%</b>  | <b>0.0%</b>   |
| <b>[Add auditor's note regarding the auditor's assessment of the percentage.]</b>   |              |  |   |

| STATEMENT OF {NAME OF STATEMENT}  |              |  |   |
|---|--------------|--|---|
| A   | B            | C  | D   |
|   | Doc.<br>Ref. | Estimated Amounts  |   |
|   |              | Absolute Value<br>Effect of Factors<br>Not Directly<br>Affecting the<br>Materiality<br>Benchmark | Net Effect of Factors<br>Directly Affecting the<br>Materiality<br>Benchmark, Upon<br>the Materiality<br>Benchmark |
| <b>Risk of Material Misstatement (Quantitative)</b>   |              |  |   |
| Factual Uncorrected Misstatements: <sup>1</sup>   |              | \$0  | \$0   |
| Judgmental Uncorrected Misstatements:   |              | 0  | 0   |
| <b>Subtotal: Factual and Judgmental Uncorrected Misstatements</b>   |              | <b>\$0</b>   | <b>\$0</b>  |
| <b>Estimate of Potential Undetected Misstatements:</b>  |              |  |   |
| Untested Amounts  |              | 0  | 0   |
| Combined Sampling Precision; Non-MUS Sample(s)  |              | 0  | 0   |
| Combined Sampling Precision; MUS Sample(s)  |              | 0  | 0   |
| <b>[Include Performance Materiality amount if no sampling was performed (and therefore, no global upper error limit amount was included in the 2 rows above)]</b> |              | 0  | 0   |
| Limits Related to Analytical Procedures Relied Upon as the Only Substantive Test (Complete Reliance)  |              | 0  | 0   |
| Other <sup>2</sup>  |              | 0  | 0   |
| <b>Subtotal: Estimated Quantitatively Measurable Undetected Misstatements</b>   |              | <b>\$0</b>   | <b>\$0</b>  |
| <b>Total Estimated Quantitatively Measurable Misstatements</b>  |              | <b>\$0</b>   | <b>\$0</b>  |
| <b>Materiality Benchmark (\$ amount and benchmark used)</b>   |              | <b>[Add \$ amount of benchmark used here]</b>  | <b>[Describe benchmark used (total assets, total cost, etc.)]</b>   |
| <b>Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark</b>   |              | <b>0.0%</b>  | <b>0.0%</b>   |
| <b>[Add auditor's note regarding the auditor's assessment of the percentage.]</b>   |              |  |   |

**Explanatory Comments<sup>2</sup>**

<sup>1</sup>Include only the identified factual misstatements due to errors arising from nonstatistical selections or other nonstatistical tests. The full estimated effect of the outcome of statistical tests (projected misstatement) will be included in the combined sampling precision calculations, including the related factual amount.

<sup>2</sup>Describe in "Explanatory Comments" section, any factor that does not fall into one of the listed categories.

## Consideration of Other Factors

- .21 Consider the (1) risk of undetected material misstatement arising from analytical procedures upon which we placed only partial reliance, (2) risk of material understatement, and (3) risk of material misstatement affecting amounts on the financial statements which do not affect the materiality benchmark when considered in relation to the total of the amounts they do affect.
- .22 There may also be conditions which reduce the risk of material misstatement, in terms of (1) reducing the risk that a misstatement has occurred, and/or (2) reducing the risk that users will perceive a misstatement to be material if it has occurred. On Tab III, list and assess any mitigating factors that are relevant to the uncorrected misstatements and undetected misstatements listed on Tab II. Index to appropriate support.
- .23 In each section, blank rows may be used and if needed, more rows added for additional factors specific to any given audit.

| Description                          |   | Explanatory Comments |
|--------------------------------------|---|----------------------|
| <b>Other Nonquantitative Factors</b> |   |                      |
| 1                                    | Imprecision of analytical procedures upon which only partial reliance was placed  |                      |
| 2                                    | Risk of material understatement   |                      |
| 3                                    | Risk of material misstatement affecting balances and financial statements that do not affect the materiality benchmark (Tab II, Column C), when considered in relation to the total of the amounts they do directly affect <sup>(1)</sup> |                      |
| 4                                    | Consideration of all corrected misstatements identified   |                      |
| 5                                    | <i>{insert other factors - reconsider factors noted in FAM 540.10}</i>  |                      |

| Description   |   | Explanatory Comments |
|---|---|----------------------|
| <b>Consideration of Mitigating Factors <sup>(2)</sup></b> |   |                      |
| 1   | <i>{example}</i> Conclusion that internal control was effective, particularly if there is convincing evidence that the entity monitors internal control over financial reporting in a manner sufficiently effective to further reduce the risk of material misstatement |                      |
| 2   | <i>{example}</i> Final, overall analytical procedures did not identify any material changes that were not adequately explained and supported  |                      |
| 3   | <i>{insert other mitigating factors}</i>  |                      |

**Notes:**

<sup>1</sup>For example, if the materiality benchmark is total assets; exposure affecting liability amounts on the balance sheet would not directly affect the benchmark and would therefore be entered to column C on Tab II. As a qualitative factor, the auditor should assess whether the quantifiably measurable exposure affecting liability amounts, when considered in relation to total liabilities, was relevant and potentially significant.

<sup>2</sup>Conditions which may reduce the risk of material misstatement, in terms of (1) reducing the risk that a misstatement has occurred, and/or (2) reducing the risk that users will perceive a misstatement to be material if it has occurred.

## **550 – Perform Other Reporting Phase Audit Procedures**

- .01 The auditor should perform procedures to
- obtain legal representations (see FAM 550.02 through .04);
  - identify material subsequent events and subsequently discovered facts (see FAM 550.05 through .09);
  - obtain management representations (see FAM 550.10 through .14);
  - assess related party relationships and transactions (see FAM 550.15);
  - communicate with those charged with governance (see FAM 550.16 through .19);
  - assess RSI and other information (see FAM 550.20); and
  - consider the entity's ability to continue as a going concern (see FAM 550.21).

### **Obtain Legal Representations**

- .02 As discussed in FAM 280, 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 required by AU-C 501.16 through .23 and the supplement in FAM 1002. In considering any liabilities, contingencies, or uncertainties that may affect the federal entity or its financial statements, the auditor should seek direct communication with and obtain representations from the entity's in-house and external legal counsel regarding litigation, claims, and assessments that may give rise to a risk of material misstatement (AU-C 501.16 through .19). The auditor should do so through a letter of inquiry, prepared by management, and sent by the auditor requesting the entity's legal counsel to communicate directly with the auditor (AU-C 501.18). Further guidance on these inquiries, as well as on interpreting and using responses received from legal counsel, is provided in AU-C 501, FAM 1002, Office of Management and Budget (OMB) audit guidance, and FAM 280. See FAM 1002 for an example letter of inquiry.
- .03 The Department of Justice (Justice) may be involved as the legal counsel of the federal entity under audit; Justice's level of involvement as an external legal counsel may vary. In considering whether to obtain legal representations from Justice, the auditor should consider Justice's level of involvement in litigation affecting the entity. If the auditor determines not to obtain legal representations directly from Justice, the auditor should document such determinations in accordance with AU-C 501.18 through .20.
- .04 The inquiries and responses should cover the entire period (or as close as practicable) under audit and the subsequent period through the date of the auditor's report. It is preferable that the entity's legal counsel's response be as close to the date of the auditor's report as practicable in the circumstances (AU-C 501.A53). The auditor may specify the earliest acceptable effective date of a response and the latest date by which it is to be sent to the auditor. If a long period elapses from the date of the legal counsel's response to the date of the auditor's report or to the report release date, the auditor should obtain an update, either written or oral (and include in audit documentation), to identify whether



there have been any significant changes in legal representation letter matters occurring up to the audit report date or report release date.

## **Identify Material Subsequent Events and Subsequently Discovered Facts**

- .05 Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report. The auditor should perform audit procedures to obtain sufficient appropriate audit evidence that all subsequent events that require adjustments of, or disclosure in, the financial statements have been identified (AU-C 560.09). The auditor should perform procedures required by AU-C 560.10, which are included in FAM 1005. See AU-C 560 and FAM 1005 for additional guidance. If, as a result of these performed procedures, the auditor identifies subsequent events that require adjustment of, or disclosure in, the financial statements, the auditor should determine whether each such event is appropriately reflected in the financial statements in accordance with U.S. generally accepted accounting principles (U.S. GAAP) (AU-C 560.11).
- .06 The auditor should perform subsequent event procedures near the completion of the audit and should include any events between the date of the financial statements and the date of the auditor's report. If a long period elapses from the date of the auditor's report to report release date, the auditor should update the procedures through the report release date.
- The auditor should follow AU-C 560.13 and AU-C 700 on dating the auditor's report if management appropriately revises the financial statements for subsequent events and should obtain updated or additional representations from management, as appropriate. See AU-C 560.13. If management does not appropriately revise the financial statements for a subsequent event, the auditor should modify the opinion (express a qualified or an adverse opinion), as discussed in AU-C 705, FAM 580, and AU-C 560.14.
- .07 The auditor is not required to perform any procedures regarding the financial statements after the date of the auditor's report (AU-C 560.12). The auditor may inquire of management to determine if it is aware of subsequently discovered facts (defined as facts that become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to revise the auditor's report—see AU-C 560.07) that could materially affect the financial statements (see FAM 1005.05). If the auditor becomes aware of a subsequently discovered fact before the report release date, the auditor should
- discuss the matter with management and, when appropriate, those charged with governance and
  - determine whether financial statements need revision and, if so, inquire how management intends to address the matter in the financial statements (see AU-C 560.12).
- If a subsequently discovered fact becomes known to the auditor after the report release date, the auditor should follow AU-C 560.15 through .18.
- .08 The auditor should inquire of management and, when appropriate, those charged with governance about whether there were any changes in internal control over

financial reporting or conditions that might significantly affect internal control over financial reporting subsequent to the as of date but before the date of the auditor's report (AU-C 940.48), and perform the procedures in AU-C 940.48, which are also included in FAM 1005.

If the auditor becomes aware of any such changes in internal control, the auditor should determine whether the changes significantly affect the effectiveness of the entity's internal control and the impact on the auditor's report, as discussed in FAM 580.

- .09 The auditor has no responsibility to keep informed of events subsequent to the date of the report on internal control; however, after the release of the report on internal control, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had the auditor been aware of them. The evaluation of such subsequent information is similar to the evaluation of facts discovered subsequent to the date of the report on an audit of financial statements, as discussed above.

## Obtain Management Representations

- .10 As discussed in FAM 280.03, the auditor should request written representations from entity management with appropriate responsibilities for the financial statements and knowledge of the related matters (AU-C 580.09) (this may include those charged with governance when appropriate). These representations should be in the form of a representation letter addressed to the auditor (AU-C 580.21). These representations supplement the other audit procedures performed by the auditor but are not a substitute for them. Written representations help avoid any misunderstandings that could arise if only oral representations were received from management. In some circumstances, corroborating evidence for representations may not be readily available, such as for those involving management's intent concerning a future transaction or business decision.

The auditor should request that entity management provide the representations required by AU-C 580.10 through .19, including that management has fulfilled its responsibilities, as set out in the terms of the engagement. If the auditor is engaged to express an opinion on the effectiveness of internal control over financial reporting, the auditor should request that management provide the representations required by AU-C 940.57. These representations are discussed further in FAM 1001 and included in the example representation letter in FAM 1001 A.

Additionally, the auditor generally should determine whether to request representations on other matters unique to the entity under audit. If the auditor determines that it is necessary to obtain specific representations to support other audit evidence, the auditor should request such representations (AU-C 580.19). Examples of written representations obtained from management are provided in AU-C 580.A35 and .A36. Additional guidance for these representations is provided in FAM 1001 and the example representation letter provided at FAM 1001 A.

- .11 Auditors should obtain further representations from management in addition to those required by U.S. generally accepted auditing standards. Such further management representations concern management's assessment of the

effectiveness of internal control and assumptions regarding the statement of social insurance, as applicable. For CFO Act agencies, auditors also should obtain management representations about substantial compliance of the entity's financial management systems with the three requirements of FFMIA. Additionally, OMB audit guidance includes representations regarding the consistency of budget data in the statement of budgetary resources and specific budget data submitted for preparing the annual budget of the U.S. government.

If the auditor has concerns about the competence, integrity, ethical values, or diligence of management or about management's commitment to, or enforcement of, these, the auditor should determine the effect that such concerns may have on the reliability of representations (oral and written) and audit evidence in general (AU-C 580.22).

- .12 If a representation is inconsistent with other audit evidence, the auditor should perform audit procedures, such as identifying and understanding the circumstances to attempt to resolve the matter. If the matter remains unresolved, or if management does not provide one or more of the requested representations, the auditor should (a) discuss the matter with management; (b) reconsider the assessment of the competence, integrity, ethical values, or diligence of management or of management's commitment to, or enforcement of, these; and (c) determine the effect that these may have on the reliability of representations and audit evidence in general (AU-C 580.23 and .26). The auditor should also determine whether this may indicate a scope limitation sufficient to preclude an unmodified opinion (AU-C 580.24 and .26). If the auditor concludes that management's written representations are not reliable or complete, the auditor should consider the effects on the assessment of risk and the integrity of management. Further, the auditor should determine its ability to complete the audit and/or the effects on the auditor's report. See FAM 580 for additional reporting guidance (AU-C 580.25). For example, in the case of identified inconsistencies between one or more written representations and audit evidence obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, may revise the risk assessment and determine the nature, timing, and extent of further audit procedures to respond to the assessed risks.

In an audit of internal control over financial reporting performed as part of an integrated audit, the failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the examination. The auditor should evaluate the effects of management's refusal on the auditor's ability to rely on other representations, such as those obtained during the audit of the entity's financial statements. See AU-C 940.73 through .77 for additional guidance and determine the effect on the auditor's report, as discussed in FAM 580.

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 completion of the audit. This is particularly true for first year audits, when standards change, and when management changes (see FAM 280.03).

- .13 The auditor should request that members of management and, when appropriate, those charged with governance, who are responsible for and

knowledgeable, directly or through others, about the preparation and fair representation of the financial statements, for the completeness of the information provided to the auditor, and other matters in the representation letter, sign the letter (AU-C 580.06). As discussed in OMB audit guidance, the signers generally should be officials at the highest levels of the audited entity responsible for overseeing the financial reporting process and generally should be the head of the entity, the CFO, and any others deemed responsible for matters presented in this letter.

- .14 Entity management should date the representation letter as of the date of the auditor's report. Typically, senior management will review the final financial statements and disclosures to take responsibility for them before signing the representation letter. Although the auditor is not required to perform audit procedures regarding the financial statements after the date of the auditor's report, the auditor may determine that an updated management representation letter is necessary to provide evidence concerning events subsequent to the report date. For example, the auditor may determine that updated management representations are needed to (1) support a determination that subsequent events identified after the report date do not require revisions to the financial statements; (2) support a revised report date due to revisions to the financial statements as a result of a subsequent event; or (3) provide evidence that no subsequent events have occurred, particularly where the financial statements are not issued shortly after the audit report release date.

### **Assess Related Party Relationships and Transactions**

- .15 The auditor should evaluate whether the identified related party relationships and transactions have been appropriately accounted for and disclosed. The auditor should also evaluate whether the effects of the related party relationships and transactions prevent the financial statements from achieving fair presentation (AU-C 550.26). FAM 280, FAM 904, and AU-C 550 provide guidance on related party relationships and transactions. Such related party relationships and transactions may include, as defined by FASAB, disclosure entities, related parties, and public-private partnerships (FAM 904.03). SFFAS 47 provides the definitions of related parties and disclosure entities and related disclosure requirements for federal entities. SFFAS 49 provides the criteria for public-private partnerships and related disclosure requirements for federal entities.

### **Communicate with Those Charged with Governance**

- .16 The auditor should communicate with those charged with governance findings and issues from the audit that are, in the auditor's professional judgment, significant and relevant to their responsibility to oversee the financial reporting process. Those charged with governance are those responsible 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. At the start of the audit, as part of gaining an understanding of the entity, the auditor should have identified those charged with governance for the entity (see FAM 215). As discussed in FAM 215, in some instances, those charged with governance may include management. The auditor should communicate the following with those charged with governance:

- a. The auditor's views about qualitative aspects of significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. When applicable, the auditor should take the following actions:
  - Explain to those charged with governance why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be the most appropriate to the particular circumstances.
  - Determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusion regarding the reasonableness of those estimates (AU-C 260.12.a). See AU-C 260.A24 through .A25 for items the auditor may consider communicating related to accounting practices.
- b. Significant difficulties, if any, that the auditor encountered during the audit (AU-C 260.12.b). See AU-C 260.A26 and AU-C 730.06 for examples of difficulties, such as significant delays in receiving required information, extensive unexpected effort necessary to obtain sufficient appropriate audit evidence, an unnecessarily brief time within which to complete the audit, and inability to complete procedures related to RSI.
- c. Uncorrected misstatements, other than those the auditor believes are clearly trivial, if any, and the effect that they, individually or in the aggregate, may have on the auditor's opinion on the financial statements (see FAM 595 C, example 2). The auditor should request correction of these misstatements and should communicate the material uncorrected misstatements individually. When there are a large number of individually immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each uncorrected misstatement. The auditor should also communicate the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements taken as a whole (AU-C 260.13). The auditor generally should discuss the reasons for, and the implications of, failing to correct misstatements, taking into account the size and nature of a misstatement judged in the surrounding circumstances, and possible implications with regard to future financial statements (AU-C 260.A30).
- d. Any disagreements with management, regardless of whether they were satisfactorily resolved, about matters that individually or in the aggregate could be significant to the entity's financial statements or the auditor's report (AU-C 260.12.c). Examples of disagreements are included in AU-C 260.A28. For this purpose, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.
- e. Other findings or issues, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process (AU-C 260.12.d).

- f. Unless all of those charged with governance are involved in managing the entity, the auditor also should communicate
  - Material corrected misstatements that were brought to the attention of management as a result of audit procedures (see FAM 595 C, example 3) (AU-C 260.14.a).
  - Management representations requested by the auditor (AU-C 260.14.d). The auditor may provide those charged with governance a copy of management's written representations (AU-C 260.A33).
  - The auditor's views about significant matters that were the subject of management's consultations with other accountants, if any, on accounting and auditing matters when the auditor is aware that such consultation has occurred (AU-C 260.14.c).
  - Any significant findings or issues arising from the audit that were discussed with management or that were the subject of correspondence with management (AU-C 260.14.b). AU-C 260.A32 includes examples of significant matters that the auditor may communicate.
- g. Identified or suspected fraud involving (1) management, (2) employees who have significant roles in internal control, and (3) others when the fraud results in a material misstatement in the financial statements. If the auditor suspects fraud involving management, the auditor should discuss the nature, timing, and extent of audit procedures necessary to complete the audit. Also, the auditor should discuss any other matters involving fraud that are, in the auditor's professional judgment, relevant to those charged with governance's responsibility (AU-C 240.40 through .41).
- h. Suspected noncompliance with laws and regulations, when the auditor determines it is appropriate to discuss with those charged with governance (AU-C 250.18).
- i. Procedures performed relating to other information included in documents containing the audited financial statements and the results of these procedures (AU-C 720.08).
- j. Matters involving identified or suspected noncompliance with laws and regulations that come to the auditor's attention during the audit, unless clearly inconsequential (AU-C 250.21). If, in the auditor's professional judgment, the matter is believed to be intentional and material, the auditor should communicate the matter as soon as practicable (AU-C 250.22).
- k. Significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit (AU-C 265.11). For an integrated audit, the auditor should communicate in writing to management and those charged with governance significant deficiencies and material weaknesses identified during the integrated audit, including those that were remediated during the integrated audit and those that were previously communicated but have not yet been remediated (AU-C 940.59).
- l. Significant findings and issues in connection with the entity's related parties, unless all those charged with governance are involved in managing the entity (AU-C 550.27).

- m. If management has imposed a limitation on the scope of the audit and refuses to remove the limitation, the auditor should communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity (AU-C 705.11 and .12).
- n. A material misstatement of the financial statements that relates to the omission of information required to be presented or disclosed (AU-C 705.20).
- o. If the auditor expects to modify the opinion, the circumstances that led to the expected modification of the opinion and the proposed wording of the modification (AU-C 705.29).
- p. If the auditor expects to include an emphasis-of-matter and/or other-matter paragraph in the auditor's report, this expectation and the proposed wording of this paragraph (AU-C 706.09).
- q. A material inconsistency or material misstatement of fact that requires revision to other information and management refuses to make the revision (AU-C 720.12, .15, and .18).
- r. 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.

AU-C 260.A23 through .A33 provide further guidance on these matters.

- .17 As discussed in FAM 215.31, the auditor should communicate significant findings and issues in writing if, in the auditor's professional judgment, oral communication would not be adequate (AU-C 260.16). 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.A39 through .A41. Effective communication may involve formal presentations and written reports as well as less formal communications, including discussions (AU-C 260.A39 through .A41).

As discussed in FAM 215.35 and .36, the auditor should communicate with those charged with governance on a timely basis and should document all communications, including when and to whom they were made (AU-C 260.18 and .20).

- .18 The auditor should evaluate the adequacy of the two-way communication between the auditor and those charged with governance for the purposes of the audit. Inadequate two-way communication may indicate an unsatisfactory control environment, which will influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements. The auditor does not need to design specific procedures to evaluate the adequacy of this communication. The auditor may base the evaluation on observations resulting from other audit procedures. Such observations may include the following:
- The appropriateness and timeliness of actions taken by those charged with governance in response to matters communicated by the auditor.
  - The apparent openness of those charged with governance in their communications with the auditor.

- The willingness and capacity of those charged with governance to meet with the auditor without management present.
  - The apparent ability of those charged with governance to fully comprehend matters communicated by the auditor, such as the extent to which those charged with governance probe issues and question recommendations made to them.
  - Difficulty in establishing with those charged with governance a mutual understanding of the form, timing, and expected general content of communications.
  - When all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities. (AU-C 260.19, .A44, .A45)
- .19 If the two-way communication between the auditor and those charged with governance is not adequate, the auditor should evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and should take appropriate action. If the situation cannot be resolved, the auditor may take actions as discussed in AU-C 260.A46, including modifying the auditor's opinion for a limitation on the scope of the audit (AU-C 260.19 and .A46).

### **Assess RSI and Other Information**

- .20 The auditor should conclude on procedures performed for RSI and other information. For RSI, the auditor should determine whether there are any omissions or material departures from FASAB guidance based on the procedures performed in FAM 280.05. For other information, the auditor should determine whether there are any material inconsistencies with the audited financial statements based on the procedures performed in FAM 280.06. Further, if the auditor finds a misstatement of fact, the auditor should consult AU-C 720. See FAM 580 regarding how the auditor reports on the work performed in these areas.

### **Consider the Entity's Ability to Continue as a Going Concern**

- .21 The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time based on the results of the audit procedures performed pursuant to AU-C 570.



## **560 – Determine Whether Financial Statement Presentation Is in Accordance with U.S. Generally Accepted Accounting Principles**

- .01 U.S. GAAP for federal government entities is promulgated by FASAB. 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 FASB standards, see SFFAS 34.
- .02 FASAB established the hierarchy of accounting principles for federal entities in SFFAS 34. This hierarchy is presented below, from most authoritative to least authoritative.
  - a. FASAB Statements and Interpretations and AICPA and FASB pronouncements made applicable to federal governmental entities by a FASAB Statement or Interpretation.
  - b. FASAB Technical Bulletins and the following pronouncements if the AICPA specifically made them applicable to federal governmental entities and FASAB cleared them: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.
  - c. AICPA Accounting Standards Executive Committee Practice Bulletins if specifically made applicable to federal governmental entities and cleared by FASAB and Technical Releases of its Accounting and Auditing Policy Committee.
  - d. Implementation guides published by FASAB staff and practices that are widely recognized and prevalent in the U.S. government.
- .03 In the absence of a pronouncement in the above hierarchy, the auditor may evaluate other accounting literature, including
  - a. FASAB Concepts Statements;
  - b. pronouncements in categories a through d in FAM 560.02 when not specifically made applicable to federal governmental entities;
  - c. FASB and Government Accounting Standards Board (GASB) Concepts Statements;<sup>1</sup>
  - d. GASB Statements, Interpretations, and Technical Bulletins;
  - e. AICPA Issue Papers;
  - f. International Accounting Standards of the International Accounting Standards Committee;

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<sup>1</sup>GASB establishes U.S. GAAP for units of state and local governments.

- g. pronouncements of other professional associations or regulatory agencies;
  - h. AICPA Technical Practice Aids; and
  - i. accounting textbooks, handbooks, and articles.
- .04 Entities summarize their significant accounting policies, usually in note 1 to the financial statements.
- .05 The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with U.S. GAAP or other applicable financial reporting framework (AU-C 330.26). (See FAM 215.14 for discussion of financial reporting framework.) This evaluation should include consideration of the qualitative aspects of the entity's accounting practices, including indicators or possible bias in management's judgments (AU-C 700.15). This evaluation should include the following:
  - a. Whether, in view of the requirements of the applicable financial reporting framework,
    - the financial statements adequately disclose the significant accounting policies selected and applied;
    - the accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
    - the accounting estimates made by management are reasonable;
    - the information presented in the financial statements is relevant, reliable, comparable, and understandable;
    - the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
    - the terminology used in the financial statements, including the title of each financial statement, is appropriate (AU-C 700.16).
  - b. Whether the financial statements achieve fair presentation should also include consideration of the following:
    - the overall presentation, structure, and content of the financial statements and
    - whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation (AU-C 700.17).
  - c. Whether the financial statements adequately refer to or describe the applicable financial reporting framework (AU-C 700.18).

The auditor can meet the requirement for the above evaluations by completing the Federal Financial Reporting Checklist.<sup>2</sup> This checklist also can assist the

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<sup>2</sup>Auditors may obtain the Federal Financial Reporting Checklist by contacting FAM@gao.gov.

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## Reporting Phase

### 560 – Determine Whether Financial Statement Presentation Is in Accordance with U.S. Generally Accepted Accounting Principles

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entity in preparing federal entity financial statements with appropriate and adequate disclosure in accordance with U.S. GAAP.

- .06 For accounting estimates with significant risks, the auditor should evaluate the adequacy of the disclosure of estimation uncertainty in the financial statements (AU-C 540.20). Even when the disclosures are in accordance with U.S. GAAP, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved. The auditor's evaluation of adequacy increases in importance the greater the range of possible outcomes of the estimate. (AU-C 540.A130)
- .07 The auditor should evaluate the impact of any instances where the financial statements are not in accordance with U.S. GAAP and should determine the effects, if any, on the auditor's report (see FAM 580.09).

## **570 – Determine Compliance with GAO/CIGIE *Financial Audit Manual***

- .01 The auditor should determine whether the audit was conducted in accordance with GAGAS and, if applicable, OMB audit guidance. The auditor should also determine whether the FAM methodology was followed. One tool the auditor should use to determine and document FAM compliance and whether there are any exceptions or deviations is the audit completion checklist in FAM 1003. If the auditor is using a different methodology and if required by contract, the auditor should use the audit completion checklist to provide a crosswalk between the audit methodology used and the FAM.

## **580 – Draft Reports**

- .01 At the conclusion of the audit, the auditor should draft written reports, which include the auditor’s conclusions on
- the financial statements (see FAM 580.02 through .42);
  - internal control over financial reporting (see FAM 580.43 through .73);
  - for CFO Act agencies, whether the financial management systems comply substantially with the requirements of FFMIA—federal financial management systems requirements, federal accounting standards (U.S. GAAP), and the *U.S. Government Standard General Ledger* (SGL) at the transaction level (see FAM 580.74 through .78);<sup>1</sup> and
  - compliance with applicable laws, regulations, contracts, and grant agreements (see FAM 580.79 through .86).

The auditor should also include in the draft written reports a description of the procedures performed (FAM 280.05 through .06) on

- RSI, including MD&A (see FAM 580.16 and 580.37), and
- other information included in documents containing the audited financial statements (see FAM 580.16 and 580.37).

### **Financial Statement Reporting**

- .02 The auditor should form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework (AU-C 700.13).

### **Audit Scope**

- .03 To express an opinion, first the auditor should determine if the audit has been conducted in accordance with GAGAS and, if applicable, OMB audit guidance. The auditor should conclude whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error (AU-C 700.14a), as discussed in FAM 560 and 570. If the auditor is not able to perform all procedures considered necessary, the scope of the audit is restricted, and the auditor should consider whether to modify the GAGAS compliance statement in the report, as discussed in GAGAS (2018) 2.17b, 2.18 and 2.20, and determine whether to qualify or disclaim an opinion.
- .04 Limitations on the scope of the auditor’s work resulting in the auditor’s inability to obtain sufficient, appropriate audit evidence may be imposed by the entity, may be caused by circumstances beyond the entity’s control, or may result from circumstances related to the nature or the timing of the audit work. Examples of scope limitations are included in AU-C 705.A8 through .A12. Limitations imposed

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<sup>1</sup>Non-GAO auditors may combine bullets 3 and 4.

- by the entity may have other implications for the audit, such as the auditor's assessment of risk of material misstatement due to fraud.
- .05 The auditor should conclude whether sufficient, appropriate audit evidence has been obtained to reduce the risk of undetected material misstatements to an appropriately low level in the financial statements. When forming this conclusion, the auditor should consider all relevant audit evidence regardless of whether it appears to corroborate or contradict the assertions in the financial statements (AU-C 330.28). AU-C 330.A75 presents factors that may influence this conclusion on the sufficiency and appropriateness of audit evidence.
- .06 The auditor should determine whether any misstatements affect the audit scope from a qualitative standpoint. The auditor should also determine whether the audit scope is adequate in light of any misstatements or other findings that indicate substantial noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.
- .07 If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion, the auditor should attempt to obtain further audit evidence (AU-C 330.29). If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should consider whether to express a qualified opinion or to disclaim an opinion and include the reasons for that inability in the basis for the modification paragraph (AU-C 705.21).
- .08 Whether to qualify or disclaim an opinion because of a scope limitation is a matter of the auditor's professional judgment. The auditor should assess how important the omitted procedures were to the auditor's ability to form an opinion on the financial statements based on sufficient, appropriate audit evidence. This assessment is influenced by the nature, significance, and magnitude of the items to which the omitted procedures relate. For example, the potential effect of a scope limitation on a material account is likely to be greater than on an immaterial account.

### **Departure from U.S. GAAP (Misstatements)**

- .09 The auditor should evaluate whether the financial statements as a whole, including the related disclosures, are materially misstated based on a departure from U.S. GAAP, as discussed in FAM 560. If such a departure exists, the auditor should determine the effects of the departure on the financial statements, considering both quantitative and qualitative aspects. The auditor should conclude whether the effects of the misstatements, individually or in the aggregate, are (1) material and (2) pervasive to the financial statements. See FAM 580.29 for further discussion.
- .10 In rare cases when the auditor can demonstrate that compliance with U.S. GAAP would result in misleading financial statements, the auditor may issue an unmodified opinion that includes a description of the nature of the departure; the effects, if practicable; and why compliance with U.S. GAAP would result in misleading financial statements. The reviewer should approve the auditor's conclusion in these circumstances.

## **Uncertainties**

- .11     Uncertainties are matters affecting the financial statements whose outcome is expected to be resolved at a future date when conclusive evidence becomes available and that could result in a modified opinion. Uncertainties may be related to the resolution of litigation or the valuation of assets, such as real estate owned, and include the contingencies discussed in SFFAS 5, as amended by SFFAS 12, as well as other matters (see FAM 905 for discussion of auditing accounting estimates). In these circumstances, management is responsible for estimating the effect of future events on the financial statements or determining that a reasonable estimate cannot be made and making the required disclosures, based on management's analysis of existing conditions. An audit includes an assessment of whether the audit evidence is sufficient to support management's analysis. Absence of information related to the outcome of an uncertainty does not necessarily indicate that the audit evidence supporting management's assessment is not sufficient. Rather, the auditor's professional judgment regarding the sufficiency of the audit evidence is based on the audit evidence that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient appropriate audit evidence supports management's assessments about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unmodified opinion ordinarily is appropriate (AU-C 705.A13).

In cases involving multiple uncertainties, the auditor may conclude that it is not possible to form an opinion on the financial statements as a whole due to the interaction and possible cumulative effects of the uncertainties (AU-C 705.A14).

The auditor should express an unmodified opinion if, in the auditor's judgment, evidence is sufficient to support management's analysis of the nature of the uncertainty and its presentation or disclosure in the financial statements. The auditor may also add an emphasis-of-matter paragraph.

## **Comparative Information and Inconsistencies with Financial Statements**

- .12     Comparative information is defined as prior period information presented for purposes of comparison with current period amounts or disclosures that is not in the form of a complete set of financial statements. Comparative information includes prior period information presented as condensed financial statements or summarized financial information (AU-C 700.11).
- .13     The auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by a change in accounting principle or by adjustments to correct a material misstatement in previously issued financial statements (AU-C 708.05, AU-C 700.48 through .51). The auditor's evaluation should include all periods covered by the auditor's opinion or the prior period if the auditor's opinion only covers the current period, regardless of whether the prior period's financial statements are presented. The auditor should also evaluate whether the financial statements for the periods being reported on are consistent with previously issued financial statements for the relevant periods (AU-C 708.06).

- .14 If the auditor identifies material inconsistencies between the comparative financial statements, the auditor will need to determine the effect on the auditor's opinion and include an emphasis-of-matter paragraph. The auditor should see AU-C 705 and AU-C 708 for further guidance. If the auditor becomes aware of a material misstatement in the prior period financial statements, the auditor should see FAM 580.91 and AU-C 700 .51 through .53 and .55.
- .15 If comparative financial statements are presented, but the prior period financial statements were not audited, the auditor should follow the reporting requirements of AU-C 700.57 or .58, as applicable.
- .16 If comparative information is presented but not covered by the auditor's opinion, the auditor should clearly indicate in the auditor's report the character of the auditor's work, if any, and the degree of responsibility the auditor is taking (AU-C 700.47).
- .17 If comparative information is presented and the auditor has been engaged to express an opinion on all periods presented, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in accordance with the applicable reporting framework (AU-C 700.48).

## Report Format

- .18 The auditor's report should clearly identify the entity audited, the annual financial statement(s) on which the auditor is reporting, and the period covered by the financial statement(s), usually the current year with comparative prior year.
- .19 Information that is not required by the applicable financial reporting framework but is nevertheless presented as part of the basic financial statements should be covered by the auditor's opinion if it cannot be clearly differentiated, such as being identified as "unaudited" (AU-C 700.59).
- .20 The auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that
  - the audit documentation has been reviewed;
  - all the statements that the financial statements comprise, including the related notes, have been prepared; and
  - management has asserted that they have taken responsibility for those financial statements (AU-C 700.41).
- .21 If the auditor identifies a material subsequent event for disclosure in the report, as discussed in FAM 550, the auditor should follow guidance in AU-C 560 with respect to report dating.
- .22 The auditor may prepare a highlights page, executive summary, and/or transmittal letter to provide a high-level presentation of the audit report and significant matters of interest to the users of federal financial reports. The auditor typically presents matters in nontechnical language so that report users can readily grasp their significance.



## **Types of Reports**

- .23 If the auditor can express an opinion, the auditor may issue one of the following opinion types: (1) unmodified or (2) modified, which may be a qualified opinion or an adverse opinion. If an opinion cannot be expressed, the auditor should issue a disclaimer of opinion report. Additionally, the auditor may be required or may choose to include an emphasis-of-matter and/or other-matter paragraph as discussed below.
- .24 Guidance on reporting is included in AU-C 700, 705, 706, 708, 720, 725, and 730 and GAGAS (2018) 6.39 through 6.41. Additionally, FAM 595 A includes an example of an unmodified report. FAM 595 B includes example wording for an auditor's report with an unmodified opinion on the financial statements and an opinion on internal controls over financial reporting where a material weakness or significant deficiency is identified. The auditor may use another reporting format; however, the format should meet the requirements of the standards listed above. GAO auditors also should document the reasons for any significant deviations from the example reporting format or language in FAM 595 A or B. When findings are extensive, the auditor may modify the report format to include findings in the report and additional details in an appendix included with the report.
- .25 If the auditor expresses an opinion only on a single financial statement, or specific elements, accounts, or items of a financial statement, the auditor should follow AU-C 805.

## **Unmodified Opinion**

- .26 In an unmodified opinion on the financial statements, the auditor concludes that the financial statements and accompanying notes are presented fairly, in all material respects, as of the specified date in accordance with U.S. GAAP (AU-C 700.19).<sup>2</sup> The auditor should follow the requirements of AU-C 700.23 through .40 regarding specific wording and structure of the auditor's report, as specified in FAM 595 A. Additionally, the auditor should include an emphasis-of-matter and/or other-matter paragraph to the unmodified report in certain circumstances, as discussed below.

## **Types of Modified Opinions**

- .27 Pervasive effects on the financial statements are those that in the auditor's professional judgment,
- are not confined to specific elements, accounts, or items of the financial statements;
  - if so confined, represent or could represent a substantial proportion of the financial statements; or
  - with regard to disclosures, are fundamental to users' understanding of the financial statements (AU-C 705.06).

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<sup>2</sup>These are usually comparative statements for the current and prior years unless it is the entity's initial audit.

The auditor should conclude whether the possible effects of undetected misstatements, if any, could be material to the financial statements and, if so, also conclude whether the possible effects are pervasive to the financial statements (AU-C 705.8b and .10).

- .28 If the audit scope is adequate for expressing an opinion on the financial statements, the auditor should determine the appropriate type of opinion. The auditor should make this determination based on
- the auditor's conclusions on whether uncorrected misstatements are material, individually or in the aggregate, to the financial statements, as discussed in FAM 540 and AU-C 450.11 (AU-C 700.14b);
  - the auditor's conclusions on whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable reporting framework, including consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments, as discussed in FAM 560.05 (AU-C 700.15);
  - the results of the auditor's evaluation of the financial statement disclosure of accounting policies, the selection of accounting policies, and other items specified in AU-C 700.16a through .16f, as discussed in FAM 560;
  - the results of the auditor's evaluation about whether the financial statements achieve fair presentation considering the factors in AU-C 700 .17a and .17b, as discussed in FAM 560; and
  - the results of the auditor's evaluation about whether the financial statements adequately refer to or describe the applicable reporting framework per AU-C 700.18 and as discussed in FAM 560.
- .29 The following table illustrates how the auditor's professional judgment about the nature of the matter giving rise to the modification and the pervasiveness of its effects or possible effects on the financial statements affect the type of opinion to be expressed (AU-C 705.A1).

| Nature of matter giving rise to the modification          | Auditor's professional judgment about the pervasiveness of the effects or possible effects on the financial statements |                        |
|---|--|------------------------|
|   | Material but not pervasive   | Material and pervasive |
| Financial statements are materially misstated             | Qualified opinion  | Adverse opinion        |
| Inability to obtain sufficient appropriate audit evidence | Qualified opinion  | Disclaimer of opinion  |

- .30 The auditor should modify the opinion in the auditor's report if the auditor concludes that based on the audit evidence obtained, the financial statements as a whole are materially misstated or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement (AU-C 700.20, AU-C 705.07).

When the auditor modifies the opinion on the financial statements, the auditor should include a paragraph in the auditor's report that provides a description of

the matter giving rise to the modification (using a heading that includes Basis for Qualified Opinion, Basis for Adverse Opinion, or Basis for Disclaimer of Opinion) (AU-C 705.17 and .22).

- a. If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole, an unmodified opinion on a specific element in the same auditor's report would contradict the adverse opinion or disclaimer of opinion on the entity's complete set of financial statements as a whole and would be tantamount to expressing a piecemeal opinion (which is prohibited). In the context of a separate audit of a specific element that is included in those financial statements, when the auditor nevertheless considers it appropriate to express an unmodified opinion on that specific element, the auditor should only do so if that opinion is expressed in an auditor's report that is neither published with nor otherwise accompanies the auditor's report containing the adverse opinion or disclaimer of opinion and
- b. the specific element does not constitute a major portion of the entity's complete set of financial statements or the specific element is not, or is not based upon, the entity's stockholders' equity or net income or the equivalent.

A single financial statement is deemed to constitute a major portion of a complete set of financial statements. Therefore, the auditor should not express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of financial statements as a whole, even if the auditor's report on the single financial statement is neither published together nor otherwise accompanies the auditor's report containing the adverse opinion or disclaimer of opinion (AU-C 705.15 and AU-C 805.21 and .22).

- .31 Emphasis-of-matter and/or other-matter paragraphs may also be included in the auditor's report when the auditor expresses a qualified or adverse opinion or disclaims an opinion.
- .32 If there is a predecessor auditor's opinion regarding the prior period's financial statements, the objective of the successor auditor still includes obtaining sufficient appropriate audit evidence regarding opening balances about whether
  - a. opening balances contain misstatements that materially affect the current period's financial statements and
  - b. 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 (see AU-C 510 for further guidance).
- .33 If the auditor concludes that the opinion on the financial statements should be modified, the auditor should revise the auditor's report to reflect the specific wording changes required by AU-C 705 .17 through .28. Specific wording is provided for qualified opinions, adverse opinions, and disclaimers of opinion.

## Qualified Opinion

- .34 The auditor should express a qualified opinion, as discussed in AU-C 705.08, when conditions exist as follows:
- the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements (see FAM 580.09) or
  - the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive. (See FAM 580.27 through .33.)

AU-C 705 provides guidance on qualified opinions.

## Adverse Opinion

- .35 An adverse opinion is expressed on the financial statements **taken as a whole** when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements (AU-C 705.09).

Guidance on adverse opinions is provided in AU-C 705.

## Disclaimer of Opinion

- .36 In a disclaimer of opinion, the auditor does not express an opinion on the financial statements. The auditor should disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive (AU-C 705.10). Guidance on a disclaimer of opinion is provided in AU-C 705.

## Emphasis-of-Matter and/or Other-Matter Paragraph(s)

- .37 The following table provides a listing of situations that could cause the auditor to add an emphasis-of-matter and/or other-matter paragraph(s) to the auditor's unmodified opinion or to modify the opinion.

| Situation   | FAM paragraph and further guidance   |
|---|--|
| <b>Relating to the financial statements</b>   |  |
| 1. Insufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement (also referred to as limitations on the scope of the audit). (AU-C 705.07.a and .b) | FAM 580.27–.33<br>AU-C 705 Illustration 4 (qualified)<br>AU-C 705 Illustrations 5 and 6 (disclaimer) |
| 2. Effects of uncertainties on an audit opinion.  | FAM 580.36   |

| Situation  | FAM paragraph and further guidance  |
|--|---|
| 3. Inconsistencies of comparability between the financial statements for all periods presented, including changes in accounting principles. (AU-C 708)   | FAM 580.41  |
| 4. Material departures from U.S. GAAP resulting in a qualified or adverse opinion. (AU-C 705.07.a)   | FAM 580.34–.35<br>AU-C 705 Illustrations 1 and 2 (qualified)<br>AU-C 705 Illustration 3 (adverse)   |
| 5. Procedures performed on RSI (which includes MD&A (AU-C 730)) and other information included in documents containing the audited financial statements (AU-C 720) and any issues identified by the auditor based on applied procedures. | FAM 580.16 and FAM 595A   |
| <b>Relating to internal control</b>  |   |
| 6. Scope limitation resulting in a disclaimer of opinion on internal control.  | FAM 580.52–.54  |
| 7. Material weaknesses and significant deficiencies in a report or opinion on internal control or other control deficiencies that the auditor has decided to describe in the audit report.   | FAM 580.56–.58<br>FAM 595 B Example 1 (material weakness in internal control)<br>FAM 595 B Example 2 (significant deficiency in internal control) |
| 8. Material inconsistencies between the Summary of Management's Report on Internal Controls prepared under FMFIA and the results of the auditor's evaluation of internal control.  | FAM 580.73  |
| 9. Purpose of audit was not to give an opinion on internal control, and significant deficiencies or material weaknesses were found.  | FAM 580.61–.62<br>AU-C 265  |
| <b>Relating to financial management systems' substantial compliance with FFMIA requirements (for CFO Act agencies)</b>   |   |
| 10. Instances of lack of entity financial management systems' substantial compliance with the three requirements of FFMIA for CFO Act agencies.  | FAM 580.74–.77  |
| <b>Relating to compliance with applicable laws, regulations, contracts, and grant agreements</b>   |   |
| 11. Scope limitation—some significant provisions of applicable laws, regulations, contracts, and grant agreements could not be tested.   | FAM 580.84–.86  |
| 12. Scope limitation—all significant provisions of applicable laws, regulations, contracts, and grant agreements could not be tested—disclaimer.   | FAM 580.84–.86  |

| Situation  | FAM paragraph and further guidance |
|--|------------------------------------|
| 13. Reportable noncompliance—instances of noncompliance with significant provisions of laws, regulations, contracts, and grant agreements that are reportable under GAGAS (which incorporates U.S. GAAS) or OMB audit guidance that are not clearly inconsequential. | FAM 580.82–.83                     |
| 14. Material noncompliance with significant provisions of applicable laws, regulations, contracts, and grants agreements.  | FAM 580.82–.83                     |

- .38 As discussed in AU-C 706, the auditor should add an emphasis-of-matter and/or other-matter paragraph when certain conditions exist. Additionally, the auditor may include emphasis-of-matter and/or other-matter paragraphs in the report based on the auditor’s professional judgment. Inclusion of an emphasis-of-matter paragraph does not affect the auditor’s opinion, including an unmodified opinion (AU-C 706.A5).

***Emphasis-of-Matter Paragraph***

- .39 If the auditor considers it necessary to draw users’ attention to a matter appropriately presented or disclosed in the financial statements that in the auditor’s professional judgment, is of such importance that it is fundamental to users’ understanding of the financial statements, the auditor should include an emphasis-of-matter paragraph in the auditor’s report, provided that the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph should refer only to information presented or disclosed in the financial statements (AU-C 706.06).

The auditor should follow the requirements of AU-C 706.07 for specific wording and placement of emphasis-of-matter paragraphs in the auditor’s report.

***Other-Matter Paragraph***

- .40 If the auditor considers it necessary to communicate a matter other than those presented or disclosed in the financial statements that in the auditor’s professional judgment, is relevant to users’ understanding of the audit, the auditor’s responsibilities, or the auditor’s report, the auditor should do so in an other-matter paragraph in the auditor’s report (AU-C 706.08). See AU-C 706.A6 through .A11 for additional guidance on other-matter paragraphs.

The auditor should follow the requirements of AU-C 706.08 for specific wording and placement of other-matter paragraphs in the auditor’s report.

- .41 The following is a list of conditions that may require the auditor to include an emphasis-of-matter and/or other-matter paragraph. This is not an all-inclusive list. The auditor should refer to the related AU-C section for further requirements and guidance. (See FAM 580.37.)
- a. Subsequently discovered facts that become known to the auditor after the report release date. See FAM 580.91, AU-C 560.16c, and AU-C 700.53 for further guidance.

- b. The auditor has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time based on the results of the audit procedures performed (see AU-C 570.15 through .16).
  - c. The accounting principles or their method of application changes between periods and the effect on the financial statements is material. For a discussion of consistency, see FAM 580.14.
  - d. Certain situations related to prior period financial statements that are audited by a predecessor auditor or are not audited (AU-C 700.54 through .57, AU-C 510).
  - e. When the auditor identifies a material inconsistency prior to the report release date that requires revision of the other information and management refuses to make the revision, the auditor should communicate this matter to those charged with governance and include in the auditor's report an other-matter paragraph describing the material inconsistency, in accordance with AU-C 706.
  - f. Procedures performed on RSI (including MD&A) and other information included in documents containing the audited financial statements and any issues identified by the auditor based on applied procedures, as discussed in FAM 280.05 and FAM 280.06 (AU-C 730.07, AU-C 720.12). If the auditor finds that management's representations about internal control in the MD&A are inappropriate, the auditor should describe the issue of the inconsistency in an Other Matters section of the auditor's report.
  - g. There is a departure from U.S. GAAP that has a material effect on the financial statements, and the auditor can demonstrate that the financial statements would be misleading without this departure (see the Code of Professional Conduct of the AICPA such as 1.320.001 Accounting Principles Rule).
- .42 GAGAS (2018) 6.57 requires the auditor to obtain and report the views of entity management concerning the findings, conclusions, and recommendations in the audit report, as well as any planned corrective actions. The entity comments and (auditor) evaluation section of the report discusses the extent to which the entity agrees with the facts and conclusions presented by the auditor and the reasons for any disagreements. The auditor should evaluate any disagreements that the entity expresses and present the auditor's view. The auditor may also outline in the report entity's description of the efforts it is taking to correct or mitigate matters. The auditor should disclaim an opinion on this information. (See FAM 580.87 through .89.)

## Internal Control

- .43 Federal financial auditors may take one of two different approaches to reporting on internal control: (1) management provides an assessment about the effectiveness of its internal control and the auditor expresses an opinion on internal control or on management's assessment following the guidance in AU-C

940 (see FAM 580.51 through .60)<sup>3</sup> or (2) the auditor reports material weaknesses and significant deficiencies found but does not give an opinion on internal control (see FAM 580.61 through .62). OMB reporting guidance requires management to include representations about internal control in the management representation letter and requires CFO Act agencies to include these representations in the MD&A in the annual financial statement. OMB audit guidance does not require auditors to express an opinion on internal control; however, the terms of the engagement may include a requirement for an auditor to express an opinion on the effectiveness of the entity's internal control over financial reporting. In either case, the auditor should evaluate whether the design and implementation of internal control is sufficient to meet the control objectives insofar as those objectives pertain to providing reasonable assurance that a misstatement or omission in the relevant assertion is prevented, or detected and corrected, on a timely basis. These control objectives are as follows:

- **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.
- **Compliance with applicable 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.

### **Classifying Control Weaknesses**

.44 A **control deficiency** 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 deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not designed effectively so that even if the control operates as designed the control objective would not be met. A deficiency in operation exists when an effectively designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively (AU-C 265.07). The auditor should classify internal control deficiencies following AU-C 265 as follows:

- 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

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<sup>3</sup>If the auditor finds no material weaknesses in internal control, the auditor may express an opinion on management's assessment or directly on internal control.



possibility<sup>4</sup> that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis (AU-C 265.07).<sup>5</sup>

To avoid confusion, the auditor should include the definitions of these terms in the auditor's report, as these definitions differ from those in other auditing standards, such as standards issued by the Public Company Accounting Oversight Board (PCAOB).

- .45 The auditor should determine whether each control deficiency or combination of control deficiencies constitutes a significant deficiency or material weakness (AU-C 265.09). The severity of a control deficiency depends not only on whether a misstatement has actually occurred but also on the magnitude of the potential misstatement resulting from the deficiency or deficiencies and whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, a misstatement of an account balance or disclosure. When making this determination, the auditor should evaluate the following:
- The likelihood and magnitude of potential misstatement that would not be prevented or detected because of the control deficiencies. AU-C 265.A6 through .A9 provide examples of factors for evaluating the likelihood and magnitude of misstatement.
  - Whether individual control deficiencies that affect the same account balance, disclosure, relevant assertion, or component of internal control collectively result in an internal control deficiency.
  - The possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the financial statement audit.<sup>6</sup>
- .46 If the auditor determines that a deficiency, or a combination of deficiencies, in internal control is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion (AU-C 265.10).

Additional guidance on evaluating identified deficiencies in internal control is provided in AU-C 265.A5. through A11. AU-C 265.A11 includes indicators of control deficiencies that the auditor should regard as indicators of a material weakness, such as the auditor's identification of a material misstatement of the financial statements under audit that was not initially identified by the entity's internal control. Additionally, circumstances that may be considered control deficiencies, significant deficiencies, or material weaknesses are described in AU-C 265.A37. Guidance on concluding on the effectiveness of internal control

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<sup>4</sup>A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable. Reasonably possible is defined as the chance of the future event or events occurring is more than remote but less than likely. Probable is defined as the future event or events are likely to occur (AU-C 265.07).

<sup>5</sup>This definition is used to determine whether a material weakness exists.

<sup>6</sup>A compensating control is a control that limits the severity of a control deficiency and prevents it from rising to the level of a significant deficiency or, in some cases, a material weakness. Compensating controls operate at a level of precision, considering the possibility of further undetected misstatements that would prevent or detect a misstatement that is more than inconsequential or material to the financial statements. Although compensating controls mitigate the effects of a control deficiency, they do not eliminate the control deficiency.

and reporting findings is provided in FAM 580.55 through .60 and FAM 580.64 through 67.

- .47 OMB Circular No. A-123 provides guidance for management to report control weaknesses under the Federal Managers' Financial Integrity Act (FMFIA). The term material weakness as used by OMB (FMFIA material weakness) is different from the above definition and includes matters of an operational nature. Management and the auditor should evaluate the material weaknesses reported under FMFIA to determine whether they meet the auditor's definitions of material weakness and significant deficiency for reporting as part of management's assessment of the effectiveness of internal control (see FAM 580.43).
- .48 For controls other than financial reporting controls, a weakness is an FMFIA material weakness if it is significant enough to be reported outside the entity, as determined by the entity head. That is, it was included in the annual FMFIA report to the President and the Congress. Entity reporting of system noncompliance is governed by the criteria for FMFIA reporting in OMB Circular No. A-123, Appendix D.
- .49 The auditor should determine how threats, incidents, and risk assessments reported in a Federal Information Security Modernization Act annual report regarding major incidents relate to the control deficiencies identified during the financial statement audit.
- .50 [Intentionally left blank]

### **Opinion on Internal Control**

- .51 Although not required by OMB audit guidance, if the auditor plans to express an opinion on internal control, the auditor's evaluation of the entity's internal control and the results of other audit procedures form the basis for this opinion. The opinion may be (1) unmodified, (2) unmodified with reference to significant deficiencies, (3) disclaimer, or (4) adverse (one or more material weaknesses). Additionally, there may be restrictions on the scope of the procedures that result in a disclaimer of opinion (see FAM 580.52 through .55). The auditor should communicate any identified internal control deficiencies (including weaknesses in operations controls), as discussed in FAM 580.64 through .71, and consider the effects of these deficiencies on other entity-prepared reports (see FAM 580.72).

### **Scope of Procedures**

- .52 When performing an audit of internal control over financial reporting, the auditor should do the following:
- a. Obtain the agreement of management that it acknowledges and understands its responsibility for the following:
    - Designing, implementing, and maintaining effective internal control over financial reporting.
    - Evaluating the effectiveness of the entity's internal control over financial reporting using suitable and available criteria.
    - Providing management's assessment about internal control over financial reporting in a report that accompanies the auditor's report.

- Supporting its assessment about the effectiveness of the entity's internal control over financial reporting with sufficient evaluations and documentation.
  - Providing the auditor with (1) access to all information of which management is aware that is relevant to management's assessment of internal control over financial reporting, such as records, documentation, and other matters; (2) additional information that the auditor may request from management for the purpose of the audit of internal control over financial reporting; and (3) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.
- b. Determine that the as of date corresponds to the balance sheet date (or period ending date) of the period covered by the financial statements (AU-C 940.06).

The auditor should evaluate the effectiveness of the entity's internal control over financial reporting using the same suitable and available criteria used by management for its assessment (AU-C 940.07). The date specified in management's assessment (the as of date of the audit) should correspond to the balance sheet date (or period ending date) of the period covered by the financial statements.

In accordance with FAM 580.52.a.iii above, the auditor should request from management a written assessment about the effectiveness of the entity's internal control over financial reporting. Management's refusal to provide a written assessment represents a scope limitation, and the auditor should apply the requirements in AU-C 940.74 through .77 (AU-C 940.08). The auditor should perform all necessary procedures, as described in FAM 300 and FAM 450 on the written assessment from management. The auditor should evaluate whether management has a reasonable basis for its assessment. For example, the assessment may be based on management's monitoring procedures (see AU-C 940.A9 through .A12 for evidence that management can use to support its assessment). The audit results alone cannot be the basis for management's assessment. When a scope limitation arises because management refuses to furnish a written assessment about the effectiveness of internal control over financial reporting, the auditor should withdraw from the integrated audit engagement. When withdrawal is not possible under applicable law or regulation, the auditor should disclaim an opinion on internal control over financial reporting and consider the implications on the financial statement audit (AU-C 940.74).

- .53 If there is a restriction on the scope of the audit, such that not all of these procedures can be performed, the auditor should evaluate whether or not to disclaim the opinion on internal control over financial reporting and determine whether or not to modify the GAGAS compliance statement in the report, as discussed in GAGAS (2018) 2.17b, 2.18, and 2.20. Scope restrictions may be imposed by the entity or may be due to other circumstances. The auditor should consult with the reviewer on this decision.

When determining the severity of a scope limitation on internal control, the auditor should use the control objectives listed in the report for internal control over financial reporting, including safeguarding assets. If the scope of work on internal control over financial reporting is limited, the auditor should disclaim the opinion on internal control. If the auditor concludes that the auditor cannot

express an opinion because there has been a limitation on the scope of the examination, the auditor should communicate, in writing, to management and those charged with governance that the audit of internal control over financial reporting cannot be satisfactorily completed.

- .54 If the auditor determines that an opinion can be expressed, the type of opinion depends on whether any internal control deficiencies are identified and the significance of such deficiencies. In identifying and evaluating deficiencies, the auditor should consider deficiencies in each of the five components of internal control (control environment, entity risk assessment, information and communications, control activities, and monitoring). In concluding on the effectiveness of internal control, the auditor should categorize control deficiencies, in order of decreasing significance, as (1) material weaknesses, (2) significant deficiencies, and (3) other deficiencies that do not meet the criteria for a significant deficiency or material weakness (other deficiencies). Each of these types of weaknesses and its effects on the auditor's conclusion on internal control is discussed below. If no material weaknesses are identified, the auditor generally should conclude that internal control is effective in meeting the control objectives.

### **Effects of Control Deficiencies on the Auditor's Conclusion on the Effectiveness of Internal Control over Financial Reporting**

- .55 Based on the types of deficiencies noted, the auditor should conclude on the effectiveness of internal control over financial reporting as of the end of the audit period, as discussed in FAM 580.56 through .59. Management also should conclude on the effectiveness of internal control in deciding what assessment to make. After forming an opinion on the effectiveness of the entity's internal control, the auditor should evaluate management's report to determine whether it appropriately contains the following:
- A statement regarding management's responsibility for internal control over financial reporting
  - A description of the subject matter of the examination (for example, controls over the preparation of the entity's financial statements in accordance with U.S. GAAP)
  - An identification of the criteria against which internal control over financial reporting is measured (for example, criteria established in the GAO's *Standards for Internal Control in the Federal Government* or the Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control-Integrated Framework*)
  - Management's assessment of the effectiveness of internal control over financial reporting
  - A description of the material weaknesses, if any
  - The date as of which management's assessment of internal control over financial reporting is made (AU-C 940.55)

If the auditor determines that any required element of management's report is incomplete or improperly presented, the auditor should request management to revise its report (AU-C 940.56). If management does not revise its report, the

auditor should modify the auditor's report to include an explanatory paragraph describing the reasons for this determination (AU-C 940.72).

### **Material Weaknesses**

- .56 If one or more material weaknesses exist at the end of the audit period, the auditor should conclude that the entity's internal control is ineffective, which would result in an adverse opinion (AU-C 940.68). The existence of a material weakness precludes a conclusion that internal control is effective, which would result in a modified opinion. If one or more material weaknesses have not been included in management's report accompanying the auditor's report, the auditor's report should be modified to state that one or more material weaknesses have been identified but not included in management's report. Additionally, the auditor's report should include a description of each material weakness not included in management's report. The auditor's description should include specific information about the nature of each material weakness and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate, in writing, to those charged with governance that one or more material weaknesses were not disclosed or identified as a material weakness in management's report. If one or more material weaknesses have been included in management's report but the auditor concludes that the disclosure of such material weaknesses is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe each material weakness (AU-C 940.70).
- .57 The auditor should determine the effect an adverse opinion on internal control over financial reporting has on the auditor's opinion on the financial statements. Additionally, the auditor should disclose, in an other-matter paragraph or as part of the paragraph that identifies the material weakness, whether the auditor's opinion on the financial statements was affected by the material weakness (AU-C 940.71). If a material weakness is presented in a report that also includes an unmodified opinion on the financial statements, the auditor should add a statement to the unmodified opinion to indicate that as a result of a material weakness, material misstatements may nevertheless occur in other financial information reported by the entity. Example report modifications for material weaknesses are provided in FAM 595 B.

### **Significant Deficiencies**

- .58 If significant deficiencies existed at the end of the audit period, but no material weaknesses were identified, the auditor generally should conclude that the controls are effective in achieving the control objectives. However, as required by GAGAS, the auditor should indicate in the report (see FAM 595 B) that the work performed identified significant deficiencies and should describe the deficiencies.

### **Control Deficiencies That Do Not Meet the Criteria for Material Weaknesses or Significant Deficiencies**

- .59 Control deficiencies that do not meet the criteria for material weaknesses or significant deficiencies in FAM 580.44 do not affect the auditor's conclusion on the effectiveness of internal control. The auditor also should communicate to management at an appropriate level of responsibility—on a timely basis either in writing (e.g., in a separate management letter, a write-up of the deficiency to

management for its concurrence with the facts, etc.) or orally—these deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that in the auditor’s professional judgment, are of sufficient importance to merit management’s attention. If these deficiencies in internal control are communicated orally, the auditor should document the communication (AU-C 265.12b). This communication should be made no later than 60 days following the report release date (AU-C 265.13). The auditor should document any oral communication of these deficiencies. When performing an integrated audit, the auditor should communicate these deficiencies in writing and inform those charged with governance when such communication was made. The auditor is not required to communicate those deficiencies that are not material weaknesses or significant deficiencies that were included in previous written communications, regardless of whether those communications were made by the auditor, internal auditors, or others within the organization (AU-C 940.62).

### Type of Opinion

- .60 As described in FAM 580.51 through .55, if the auditor is unable to apply all the audit procedures considered necessary in the circumstances, a scope limitation exists and the auditor should issue a disclaimer of opinion on internal control over financial reporting. If all the procedures considered necessary were performed, the auditor should issue one of the following opinions:
- If the auditor and management agree on the effectiveness of internal control and there are no material weaknesses, the auditor should issue an unmodified opinion on internal control (see FAM 595 A).
  - If the auditor and management agree on the effectiveness of internal control and there are no material weaknesses in internal control, but there are significant deficiencies, the auditor should issue an unmodified opinion, including a statement that internal control is effective but could be improved and referring to the significant deficiencies (see FAM 595 B).
  - If the auditor and management agree on the effectiveness of internal control and there *are* material weaknesses in internal control, the auditor should modify the opinion on internal control by (1) referring to the material weakness(es) noted in management’s assessment (which states that internal control over financial reporting is ineffective (adverse opinion)) and (2) describing the material weakness(es) (see FAM 595 B). OMB Circular No. A-123 guidance for FMFIA allows management to provide a qualified assessment of internal control effectiveness even if material weaknesses exist.
  - If the auditor and management disagree on the effectiveness of internal control, either because (1) management does not agree that material weakness(es) exist or (2) management does not appropriately modify its assessment of the effectiveness of internal control in light of the material weakness(es), the auditor should issue an adverse opinion. The existence of a material weakness precludes management from asserting that its internal control is effective. Thus, an adverse opinion is appropriate if management states that internal control is effective “except for” the material weakness

when, in the auditor's professional judgment, the material weakness indicates that internal control is ineffective (see FAM 580.56).

### **Nonopinion Report**

- .61 If the purpose of the audit is not to express an opinion on internal control, the auditor should still report any identified material weaknesses and significant deficiencies in internal control. If no material weaknesses were identified, the auditor may state in its report that no material weaknesses were found, if such reporting was agreed to as part of the terms of the engagement (see FAM 595 A). The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for users to misinterpret the amount of assurance provided by such communication (AU-C 265.16). If there are one or more material weaknesses, the auditor may state in its report that internal control was ineffective for one or more objectives. Further, the auditor should conclude whether the scope of the work and the related audit evidence are sufficient to meet the audit objectives described in the OMB audit guidance. If the work is not sufficient, the auditor should report a scope limitation.
- .62 Under AU-C 905.06, a report on internal control in which no opinion is issued is considered a by-product report. When no opinion is issued, the report provides only a limited degree of assurance about internal control, as internal control is not the primary objective of the engagement. The auditor should indicate the intended use of the internal control report because of the potential for users to misunderstand a by-product report's limited degree of assurance. Because the distribution of government audit reports is not restricted, the reports should explain their limitations. See FAM 595 A, Example 2, for an example of a report when the auditor does not provide an opinion on internal control and cautions the reader that the internal control testing performed may not be sufficient for other purposes (AU-C 905.11).

### **Where and When to Report Control Deficiencies for Nonopinion Report**

- .63 The means of communicating deficiencies in internal control depends on the type of weakness, as discussed in FAM 580.44. The auditor should communicate in writing to those charged with governance on a timely basis significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit (AU-C 265.11). The auditor also should communicate to management at an appropriate level of responsibility, on a timely basis in writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances (AU-C 265.12a). Under GAGAS, this communication is part of the auditor's report on financial statements. For other deficiencies, the auditor should communicate no later than 60 days following the report release date. However, the auditor may issue other written communication containing further details on the deficiencies. The auditor should include any material weaknesses or other significant deficiencies that were communicated in previous financial statement audits that have not yet been corrected. The auditor may do this by referring to the previously issued written communication and the date of the communication. Communicating each type of deficiency is discussed in FAM 580.68 through .72.

***Material Weaknesses and Significant Deficiencies***

- .64 The auditor should report material weaknesses and significant deficiencies in the internal control section of the auditor's report. The auditor may report these deficiencies in a separate report that is referenced to in the auditor's report on the financial statements. If management's assessment about the effectiveness of internal control is printed with the audit report, the auditor's report should refer to the discussion of the material weakness (or other significant deficiency) in management's assessment.
- .65 The auditor generally should limit the internal control section of the auditor's report to summarized information. As such, the auditor may limit the discussion of control deficiencies included in this section to providing the reader with an understanding of the nature and extent of the deficiency. The auditor may combine related control deficiencies. To the extent that any such control deficiencies contribute to a significant deficiency, the auditor generally should describe them in conjunction with the related significant deficiency.
- .66 If more complete information concerning control deficiencies is provided in other reports issued prior to or at the same time as the auditor's report, the auditor generally should refer to such other reports (such as date and title or report number) in the auditor's report. The auditor may also subsequently report significant deficiencies in more detail in a separate management report or other written communication that includes other elements of the findings, as discussed in FAM 580.68.

***Other Control Deficiencies***

- .67 The auditor should communicate to management at an appropriate level of responsibility, on a timely basis in writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication (AU-C 265.12b).

**What to Report about Control Deficiencies**

- .68 Control deficiencies identified by the auditor are findings. GAGAS (2018) 6.25 through 6.28 describe the four elements of a finding:
- **Criteria** (what should be).
  - **Condition** (what is).
  - **Cause** (why the condition occurred).
  - **Effect** (the nature of the possible past or future impact).
- .69 The auditor should decide whether to fully develop each of the four elements of a finding. The auditor uses professional judgment in determining whether to apply resources to investigate a control deficiency, based on the elements that the auditor decides to report. For each significant deficiency, the extent to which the auditor should develop the elements of a finding depends on how it is communicated.



- **Material weaknesses and significant deficiencies reported in the auditor's report:** The auditor generally should identify at least the criteria, condition, cause, and possible asserted effect (related to the nature, not necessarily amount) to permit entity management to determine the effect and to take prompt and proper corrective action. The auditor may provide recommendations to improve internal control and obtain management's response as part of entity comments on the auditor's report.
- **Significant deficiencies described briefly in the auditor's report and detailed in a separate management report:** The auditor should identify at least the condition and the criteria and generally should identify the possible asserted effect to bring them to management's attention, particularly if there are sensitive or information technology issues. The auditor may also evaluate the benefits of identifying the cause. The auditor generally should provide recommendations or suggestions to improve reported findings and obtain management's response as part of entity comments on the auditor's report.

In discussing each material weakness that meets FMFIA reporting criteria, the auditor should determine whether the material weakness was identified in the entity's FMFIA report or in the FMFIA report of the organization of which the entity is a part (see FAM 580.73).

- .70 For control deficiencies that do not meet the criteria for a material weakness or significant deficiency, the auditor need not develop all of the elements of a finding if the auditor decides to report these control deficiencies.

### **Other Considerations**

- .71 To communicate findings promptly, the auditor may issue written communications during the audit. For example, GAO issued a report to a federal entity where on an interim basis some installations were reporting in millions of dollars and others in billions of dollars, causing materially inaccurate consolidations of amounts. GAO issued this report to provide information so that the entity could improve the consistency and accuracy of amounts in time for year-end reporting. In such instances, the auditor may describe the control deficiency and see the reports as discussed in FAM 580.67.
- .72 The auditor should determine whether internal control deficiencies, particularly material weaknesses, could affect information in other reports generated by the entity for external distribution or internal decision-making. The auditor generally should make inquiries and evaluate other knowledge obtained during the audit concerning use of reports affected by these deficiencies. The auditor uses professional judgment to determine whether such reports might contain inaccuracies as a result of control deficiencies that would likely influence the judgment of report users. If so, the auditor generally should describe, in the auditor's report, the nature of such reports and the effect of control deficiencies on them. In determining if such reports are significant, the auditor should evaluate whether user judgments or management decisions based on such reports could affect the entity in amounts that would be material in relation to the financial statements.

### **Reporting on Management's FMFIA Reports**

- .73 In the internal control section of the auditor's report, the auditor should disclose whether material weaknesses or financial management systems'

nonconformance with financial systems requirements identified during the audit was identified in management's FMFIA report.

If the auditor found material weaknesses or systems' nonconformance that should have been reported under FMFIA (see FAM 580.47 through .51), the auditor should refer to such findings as indicated at FAM 580.70, and determine whether management's FMFIA process has deficiencies that the auditor should report. Such deficiencies might result from the following:

- Entity management did not initially recognize internal control deficiencies or systems' nonconformance, perhaps due to a lack of training, understanding, or limitations in the scope of the FMFIA process. For example, certain areas were not reviewed annually or certain types of controls or systems were not reviewed.
- Entity management did not recognize that identified deficiencies were FMFIA material weaknesses or systems' nonconformance.
- Entity management relied on controls that the auditor concluded were ineffective.
- Entity management failed to report identified deficiencies due to inappropriate report preparation. This could occur because of errors in aggregating the internal control deficiencies or systems' nonconformance of individual components or locations.

The auditor may refer to the assessment of management's FMFIA process performed during planning, as discussed at FAM 260.65 through .70, when concluding as to how to report these matters.

## **Financial Management Systems**

.74 FFMIA requires the auditor to report whether the financial management systems of the 24 CFO Act agencies comply substantially with three federal financial management systems requirements. These requirements are as follows:

- Federal financial management systems requirements, including those found in the Treasury Financial Manual, Volume 1, Part 6, Chapter 9500, *Revised Federal Financial Management System Requirements*.
- Applicable federal accounting standards
- The SGL at the transaction level.

Further information on FFMIA compliance can be found in OMB Circular No. A-123, Appendix D.

The auditor should conclude on whether the agency's financial management systems complied substantially with the three FFMIA requirements, following the guidance provided in FAM 701 and by OMB.

### **Reporting on Systems' Substantial Compliance with FFMIA Requirements**

.75 If the auditor is required to report whether an agency's financial management systems comply with the three FFMIA requirements, the example reports in FAM 595 A should be revised to include this item. OMB audit guidance provides information for reporting on FFMIA compliance without expressing an opinion.

- .76 If the auditor finds that the entity's financial management systems do not comply substantially with any of the three FFMIA requirements, the auditor should summarize the lack of substantial compliance in the auditor's report. Frequently, the financial management systems' lack of substantial compliance is related to significant deficiencies in internal control. If so, the auditor may make reference to another report or another section within a combined report, as necessary.
- .77 If the auditor finds that the entity's financial management systems did not comply substantially with the requirements, FFMIA requires the auditor to identify the entity or organization responsible for the systems found not to comply. The auditor should include pertinent facts, such as the nature and extent of noncompliance, areas in which there is substantial but not full compliance, primary reason or cause, and any relevant comments from management or responsible employees. The auditor may make recommendations for corrective actions and obtain management's response as part of agency comments on the auditor's report.

#### **Scope of Procedures**

- .78 If the auditor is unable to perform all the procedures considered necessary, as discussed in FAM 350, the scope of the financial statement audit is restricted. Generally, if the scope of the financial statement audit is restricted, for example, because needed information from the systems is not available, the auditor should report that the financial management systems do not comply substantially with FFMIA requirements. Also, if the auditor concluded that the systems did not comply substantially with FFMIA based on limited testing, the auditor should report that the work on FFMIA would not necessarily disclose all instances of noncompliance with FFMIA requirements.

### **Compliance with Applicable Laws, Regulations, Contracts, and Grant Agreements**

- .79 The auditor should report on the results of compliance testing and on compliance matters (including fraud, as discussed in FAM 540) that come to the auditor's attention during procedures other than compliance tests.
- If the auditor concludes that the noncompliance has a material effect on the financial statements, and it has not been adequately reflected in the financial statements, the auditor should, in accordance AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, express a qualified or adverse opinion on the financial statements (AU-C 250.24). If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether noncompliance that may be material to the financial statements has, or is likely to have, occurred, the auditor should express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit, in accordance with AU-C 705 (AU-C 250.25).
- .80 If the auditor concludes, based on sufficient appropriate evidence, that any of the following have occurred or are likely to occur, the auditor should include in the report on internal control or compliance the relevant information about
- fraud that is material, either quantitatively or qualitatively, to the financial statements or other financial data significant to the audit objectives or

- noncompliance with provisions of laws, regulations, contracts, or grant agreements that has a material effect on the financial statements or other financial data significant to the audit objectives (GAGAS (2018) 6.41).

The auditor should consult with the entity's legal counsel regarding conclusions on the entity's compliance with provisions of applicable laws, regulations, contracts, and grant agreements.

- .81 When the auditor identifies or suspects instances of fraud or noncompliance with provisions of laws, regulations, contracts, or grant agreements that have an effect on the financial statements or other financial data significant to the audit objectives that is less than material but warrants the attention of those charged with governance, the auditor should communicate those findings in writing to audited entity officials (GAGAS (2018) 6.44). When the auditor identifies or suspects any instances of noncompliance with provisions of applicable laws, regulations, contracts, or grant agreements that do not warrant the attention of those charged with governance, the auditor's determination of whether and how to communicate such instances to audited entity officials is a matter of professional judgment (GAGAS (2018) 6.48).

### **Reporting on Compliance Tests**

- .82 The auditor should state directly whether any reportable noncompliance was detected during compliance tests. This type of direct statement is illustrated in FAM 595 A for a situation in which the compliance tests disclosed no reportable noncompliance. If the auditor identifies any reportable noncompliance, the auditor should modify the statement, and the auditor should discuss the reportable noncompliance in the auditor's report as described in FAM 580.79 through .81.
- .83 Under AU-C 905, a report on compliance with applicable laws, regulations, contracts, and grant agreements in which no opinion is issued is a by-product of a financial statement audit that provides a limited degree of assurance about compliance. When no opinion is issued, the report on compliance is not the primary objective of the engagement. The auditor should indicate the intended use of the compliance report because of the potential for users to misunderstand a by-product report's limited degree of assurance. Because the distribution of government audit reports is not restricted, the auditor's report should explain this limitation as follows (AU-C 905.11): "However, the objective of our tests was not to provide an opinion on compliance with laws, regulations, contracts, and grant agreements applicable to [entity]. Accordingly, we do not express such an opinion."

### **Scope of Procedures**

- .84 The auditor should perform all of the procedures that the auditor determines necessary for obtaining sufficient appropriate evidence for reporting on compliance with applicable laws, regulations, contracts, and grant agreements. If the auditor is unable to perform all of the procedures for each of the significant provisions of applicable laws, regulations, contracts, and grant agreements, the auditor may be able to report solely on the applicable laws, regulations, contracts, and grant agreements tested. However, the auditor should modify the report to alert the reader that not all of the laws, regulations, contracts, and grant agreements that the auditor believed were necessary were tested.

- .85 If the scope limitation is so significant that the auditor believes that any discussion of testing could be misleading, the auditor should report that the auditor could not test compliance due to the scope limitation. The auditor should describe significant scope limitations in the auditor's report and should modify the auditor's report. The auditor also should determine the effect of such a scope limitation on the auditor's opinion on the financial statements.
- .86 If deficiencies in compliance controls are identified but no instances of noncompliance are found during compliance testing, the auditor should determine whether controls or other mitigating factors prevented or detected instances of noncompliance. If sufficient additional controls or other mitigating factors are not identified, the auditor should consult with the reviewer and OGC concerning the appropriate reporting of such deficiencies and compliance tests.

## Entity Comments

- .87 The auditor should obtain and report the views of responsible entity officials concerning the findings, conclusions, recommendations, and planned corrective actions, if included. The auditor should allow the audited entity to review a draft of the report prior to issuance and provide either written or oral comments. This agency review helps the auditor to identify any errors in fact; avoid surprises in the message; and strive for fairness, balance, objectivity, accuracy, and completeness. Written comments are generally preferred, especially when the report is sensitive or controversial, when significant disagreements exist, or when the report makes wide-ranging recommendations. When the entity provides written comments, the auditor should include a copy of these comments or summarize the comments in the auditor's report.  
  
Oral comments may be appropriate when (1) there is a reporting date critical to meeting a user's needs; (2) the auditor has worked closely with the entity so that it is familiar with the findings and issues addressed in the draft report; or (3) the auditor does not expect major disagreements with the findings, conclusions, or recommendations in the draft report or major controversies with regard to the issues discussed in the draft report. If the entity provides only oral comments, the auditor should prepare a summary of these comments and provide a copy of the summary to the responsible officials to verify that the comments are accurately stated, and may report the entity's views. If the report is unmodified and does not include any material weaknesses or material noncompliance, the entity may decide not to comment.
- .88 The auditor generally should include an entity comments and (auditor's) evaluation section in the auditor's report. The auditor generally should briefly characterize the overall response to the draft regarding facts and conclusions, such as whether the entity generally agrees, partially agrees, or disagrees with the report. The auditor generally should summarize the major points made in the comments, whether written or oral, usually in the last section of the auditor's report, and should include an evaluation of the comments, as appropriate. If entity officials concurred with all the findings, conclusions, and recommendations, the auditor should state that they concurred, mention any actions the entity has agreed to take, and provide the auditor's response to those actions. If entity officials disagree with or have concerns regarding portions of the report, the auditor should discuss these concerns in the auditor's report and provide the auditor's evaluation of them.

- .89 The auditor generally should include the entity's written comments as an appendix to the report. These comments may include, for example, a description of corrective actions taken by the entity, the entity's plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency or material weakness would exceed the benefits to be derived from doing so. If these types of comments are included in the document containing the auditor's written communication regarding material weaknesses or other significant deficiencies, the auditor should disclaim an opinion on such information.

## Dating the Auditor's Report

- .90 The auditor should date the report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion, as discussed in AU-C 700.41. When expressing an opinion on all periods presented, a continuing auditor should update the report on the financial statements of one or more prior periods, presented on a comparative basis, with those of the current period. The auditor's report on comparative financial statements should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to support the opinion for the most recent audit (AU-C 700.45).

Among other things, sufficient appropriate audit evidence includes evidence that supervisors, first partners, and the reviewer have completed their reviews; the entity's financial statements, including disclosures, have been prepared; management has asserted that it has taken responsibility for them by signing the representation letter; and any significant issues have been resolved.

However, if additional evidence is needed, the auditor should determine whether to change the date of the auditor's report. This will ordinarily result in a report date that is close to the date on which the auditor permits the entity to use the auditor's report in connection with the financial statements (report release date). If there are delays in releasing the report, the auditor should perform additional procedures to comply with AU-C 560 and AU-C 700. There are three important dates to consider.

- **Auditor's report date.** This is the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion.
- **Report release date.** This is the date on which the auditor permits the entity to use the auditor's report in connection with the financial statements. Often, the report release date will be the date that the auditor delivers the audit report to the entity. The report release date will ordinarily be a date that is close to the auditor's report date. The report release date is important because it starts the period when the auditor should complete the audit documentation.
- **Documentation completion date.** This is the date that the auditor determines that the audit documentation is assembled, final, and complete. The auditor should complete final audit documentation within 60 days following the report release date.

## **Restatement of Audited Financial Statements**

- .91 If the auditor becomes aware of information or subsequently discovered facts after the report release date, the auditor should follow AU-C 560.15 through .18. SFFAS 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, addresses restatement of prior-year federal entity financial statements. AU-C 708 (on consistency of application of U.S. GAAP) and AU-C 560 (on auditor's reports), provide guidance on when to reissue auditor's reports on restated financial statements. Additionally, OMB financial reporting guidance requires entity management to notify its auditor when material errors are found in published financial statements and provides guidance regarding footnote disclosure of restatements.

## **590 – Documentation**

- .01 The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand (1) the nature, timing, and extent of work performed in the reporting phase to comply with GAGAS; (2) the results of the audit procedures performed and the audit evidence obtained; and (3) the significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions (AU-C 230.08). The audit documentation should include, but is not limited to
- a. audit summary memorandum (FAM 590.02 through .03);
  - b. overall analytical procedures (FAM 590.04);
  - c. deficiencies in internal control (FAM 590.05);
  - d. evaluation and communication of misstatements (FAM 540);
  - e. letters from legal counsel (FAM 1002);
  - f. subsequent events (FAM 1005);
  - g. management representations (FAM 1001);
  - h. names of identified related parties and the nature of the related party relationships (AU-C 550.28);
  - i. procedures performed to determine consistency of the other information in the annual financial statement with the financial statements and in accordance with U.S. GAAP or OMB financial reporting guidance, currently OMB Circular No. A-136 (FAM 280.05 through .06);
  - j. evidences of exit conference(s) (FAM 590.12); and
  - k. applicable audit completion checklists (FAM 1003).

### **Specific Documentation Considerations**

#### **Audit Summary Memorandum**

- .02 At the completion of the audit, the auditor should prepare an audit summary memorandum that summarizes the audit results and demonstrates the adequacy of the audit procedures, appropriateness and sufficiency of the audit evidence, and the reasonableness of the conclusions on
- the financial statements;
  - internal control;
  - the financial management systems' substantial compliance with FFMIA requirements (for CFO Act agencies);
  - the entity's compliance with applicable laws, regulations, contracts, and grant agreements;
  - RSI, including MD&A; and
  - other information.



- .03 In the audit summary memorandum, the auditor may refer to other documentation that describes this information in more detail. The auditor generally should summarize and refer in the documentation to
- a. any significant changes from the auditor's original assessment of the risk of material misstatement;
  - b. any additional fraud risks or other conditions beyond those considered in planning (FAM 260), including analytical relationships identified during the audit that caused the auditor to believe that additional audit procedures or any other response was required, as well as any further response the auditor concluded was appropriate;
  - c. the results of the procedures performed to specifically address the risk of management override of controls, including the consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments (AU-C 240.44.b and 700.15);
  - d. information that demonstrates that the financial statements agree or reconcile with the underlying accounting records (AU-C 330.33);
  - e. the auditor's evaluation of misstatements that the auditor believes are or might be the result of fraud;
  - f. the nature of any communications about fraud or possible fraud (and any significant abuse) made to management, those charged with governance, the Special Investigator Unit, the Office of Inspector General, or others (AU-C 240.45);
  - g. the auditor's summary conclusions related to the consideration of fraud;
  - h. significant accounting, auditing, or reporting issues;
  - i. if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant finding or issue, the auditor should document how the auditor addressed the inconsistency (AU-C 230.12);
  - j. any limitations on the audit scope and the auditor's assessment of whether the audit procedures were adequate to support conclusions on the financial statements, internal control, the systems' substantial compliance with FFMIA requirements (for CFO Act agencies), compliance with applicable laws, regulations, contracts, and grant agreements, and MD&A, RSI, and other accompanying information;
  - k. the auditor's conclusions on whether the audit evidence obtained is sufficient, is appropriate, and supports the conclusions on the financial statements, internal control, the systems' substantial compliance with FFMIA requirements, compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements, and MD&A, RSI, and other accompanying information;
  - l. the auditor's conclusions on whether sufficient appropriate audit evidence was obtained to reduce audit risk to an appropriately low level;
  - m. the auditor's conclusion on whether the audit was performed in compliance with GAGAS, OMB audit guidance, and, if used, the FAM, and whether the report is appropriate;

- n. the auditor's conclusion on whether the entity's financial statements are in accordance with U.S. GAAP;
- o. significant subsequent events, if any;
- p. findings with respect to related party transactions and complex or unusual transactions (AU-C 940.54c.);
- q. the Summary of Uncorrected Misstatements (FAM 595 C) and communication of the misstatements to management and those charged with governance;
- r. a summary of internal control weaknesses classified as material weaknesses, other significant deficiencies, and other control deficiencies, and a comparison of material weaknesses the auditor found to the weaknesses reported in management's assessment of the effectiveness of internal control;
- s. a summary of instances of the systems' lack of substantial compliance with FFIA requirements, as well as areas in which there is substantial but not full compliance (for CFO Act agencies);
- t. a summary of instances of noncompliance with applicable laws, regulations, contracts, and grant agreements;
- u. documentation of overall analytical procedures;
- v. documentation of oral or written communication required to be communicated with management, those charged with governance (see FAM 550.20 through .21), and others, including the nature of the significant findings or issues discussed, and when and with whom the discussions took place (AU-C 230.11 and 260.20); and
- w. the auditor's conclusion on the adequacy of two-way communication with those charged with governance (see FAM 550.22 through .23).

### **Overall Analytical Procedures**

.04 The auditor should document the following:

- **Expectations:** The auditor develops these for account/line item balances based on plausible relationships that can be reasonably expected to exist.
- **Data used and sources of data:** These data consist of documentation on the specific financial data used for the current-year amounts and expectations, including the amounts of the financial items; the dates or periods covered by the data; whether the data were audited or unaudited; the persons from whom the data were obtained, if applicable; and the source of the information, such as the general ledger trial balance, prior-year audit documentation, or prior-year financial statements.
- **Parameters for identifying significant fluctuations:** These parameters are left to the auditor's professional judgment based on performance materiality.
- **Explanations for significant fluctuations from expectations and sources of these explanations:** The auditor should determine if explanations obtained are consistent with corroborating evidence in the documentation and should reference to this work.

- **Auditor's conclusions on the results of the procedures:** The auditor should document conclusions reached on the results of overall analytical procedures.

### **Deficiencies in Internal Control**

- .05 The auditor should document
- the basis for considering internal control deficiencies as material weaknesses, significant deficiencies, or other control deficiencies;
  - any oral communications of control deficiencies that are not included in a written report; and
  - procedures performed to determine the effects of deficiencies in internal control on other reports that the entity uses.

### **Lack of Systems' Substantial Compliance with FFMIA Requirements**

- .06 The auditor should document the basis for deciding whether systems' noncompliance with FFMIA requirements (for CFO Act agencies) represents a lack of substantial compliance with the three FFMIA requirements for financial management systems (FAM 580.74 through .78 and FAM 701).<sup>1</sup>

### **Instances of Noncompliance or Suspected Noncompliance**

- .07 The auditor should include a description of the identified and suspected noncompliance with applicable laws, regulations, contracts, and grant agreements; the results of discussions with management; and the results of any discussions with those charged with governance and other parties inside or outside the entity (AU-C 250.28).
- .08 The auditor should document the basis for classifying instances of noncompliance as material noncompliance, other reportable noncompliance, or not reportable. The auditor should also document any oral communications of noncompliance that are not included in a written report (FAM 580.80 through .83 and FAM 800).

### **Other Reporting Matters**

- .09 If the auditor identifies matters arising after the date of the auditor's report, the auditor should refer to AU-C 230.14 and AU-C 560.
- .10 The auditor should document procedures performed with respect to any subsequent discovery of facts that could have affected a previously issued audit report on the financial statements (FAM 580.92).

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<sup>1</sup>OMB's Bulletin on *Audit Requirements for Federal Financial Statements* contains additional information regarding FFMIA audit requirements and is updated periodically. The current version of the OMB Bulletin can be found at <https://www.whitehouse.gov/omb/information-for-agencies/bulletins>.

- .11 The auditor should document procedures performed with respect to the issuance of condensed financial statements or selected financial data (FAM 580.93).

**Exit Conference(s)**

- .12 The auditor should document exit conference(s) with appropriate entity officials. The auditor should also document any exit conference held with those charged with governance, as appropriate.

## **595 A – Example Unmodified Auditor’s Reports**

OMB audit guidance requires the auditor to report on internal control but does not require the auditor to express an opinion on the effectiveness of internal control over financial reporting. Example 1 presents a report in which the auditor expresses an opinion on the effectiveness of internal control over financial reporting. Example 2 presents a report in which the auditor has not identified any material weaknesses in internal control and does not express an opinion on internal control effectiveness. In both examples, the auditor’s opinion on the financial statements is unmodified, and no reportable noncompliance with applicable laws, regulations, contracts, and grant agreements is identified.

If the auditor is required to report whether an agency’s systems comply substantially with the three FFMA requirements, the example reports should be revised to include this item.

See FAM 595 B for modifications to the auditor’s report for a variety of situations.

**Example 1 – Unmodified Opinions on Financial Statements and Effectiveness of Internal Control over Financial Reporting, No Significant Deficiencies in Internal Control over Financial Reporting; No Reportable Noncompliance with Applicable Laws, Regulations, Contracts and Grant Agreements**

[Auditor’s Address]

**Independent Auditor’s Report**

To [appropriate addressee]

In our audits of the fiscal years [20XX and 20XX] financial statements of [entity<sup>1</sup>], we found

- [entity’s] financial statements as of and for the fiscal years ended [September 30, 20XX, and 20XX], are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles;
- [entity] maintained, in all material respects, effective internal control over financial reporting as of [September 30, 20XX]; and
- no reportable noncompliance for [fiscal year 20XX] with provisions of applicable laws, regulations, contracts, and grant agreements we tested.

The following sections discuss in more detail (1) our report on the financial statements and on internal control over financial reporting, which includes [if applicable insert “an emphasis-of-matter paragraph related to (include brief description), and”] required supplementary information (RSI)<sup>2</sup> and other information included with the financial statements;<sup>3</sup> (2) our report on compliance with laws, regulations, contracts, and grant agreements; and (3) agency comments [if applicable, add “and our evaluation” and revise related heading on page 595 A-6 for consistency].

**Report on the Financial Statements and on Internal Control over Financial Reporting**

In accordance with [cite audit authority], we have audited [entity’s] financial statements. [Entity’s] financial statements comprise the balance sheets as of [September 30, 20XX, and 20XX]; the related statements of net cost [if included in statement title, insert “of operations”], changes in net position, and budgetary resources for the fiscal years then ended; and the related notes to the financial statements. We also have audited [entity’s] internal control over financial reporting as of [September 30, 20XX], based on criteria established under

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<sup>1</sup>This example assumes the acronym of the agency does not include the word “the” in front of it as part of its common usage (example: CFPB). If “the” is part of the common usage of the acronym (example: the FBI), apply throughout the example.

<sup>2</sup>The RSI consists of [insert description of the RSI, such as “Management’s Discussion and Analysis” and the “Combined Statement of Budgetary Resources”], which are included with the financial statements.

<sup>3</sup>Other information consists of information included with the financial statements, other than the RSI [if applicable] and the auditor’s report.

31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers’ Financial Integrity Act (FMFIA).

We conducted our audits in accordance with U.S. generally accepted government auditing standards. We believe that the audit evidence we obtained is sufficient and appropriate to provide a basis for our audit opinions.

#### Management’s Responsibility

**[Entity]** management is responsible for (1) the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; (2) preparing, measuring, and presenting the RSI in accordance with U.S. generally accepted accounting principles; (3) preparing and presenting other information included in documents containing the audited financial statements and auditor’s report, and ensuring the consistency of that information with the audited financial statements and the RSI; (4) maintaining effective internal control over financial reporting, including 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; (5) evaluating the effectiveness of internal control over financial reporting based on the criteria established under FMFIA; and (6) its assessment about the effectiveness of internal control over financial reporting as of **[September 30, 20XX]**, included in the accompanying Management’s Report on Internal Control over<sup>4</sup> Financial Reporting **[or other title of management’s report]** in appendix I.

#### Auditor’s Responsibility

Our responsibility is to express an opinion on these financial statements and an opinion on **[entity’s]** internal control over financial reporting based on our audits. U.S. generally accepted government auditing standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement, and whether effective internal control over financial reporting was maintained in all material respects. We are also responsible for applying certain limited procedures to RSI and other information included with the financial statements.

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the auditor’s assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of financial statements also involves evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

An audit of internal control over financial reporting involves performing procedures to obtain evidence about whether a material weakness exists.<sup>5</sup> The procedures selected depend on the

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<sup>4</sup>Note: GAO does not capitalize the “o” in “over” in “internal control over financial reporting” when used in a heading or title. However, when referring to the title of management’s report included with the auditor’s report, the wording and capitalization should be consistent with management’s presentation.

<sup>5</sup>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.

auditor’s judgment, including the assessment of the risk that a material weakness exists. An audit of internal control over financial reporting also includes obtaining an understanding of internal control over financial reporting, and evaluating and testing the design and operating effectiveness of internal control over financial reporting based on the assessed risk. Our audit of internal control also considered [entity’s] process for evaluating and reporting on internal control over financial reporting based on criteria established under FMFIA. Our audits also included performing such other procedures as we considered necessary in the circumstances.

We did not evaluate all internal controls relevant to operating objectives as broadly established under FMFIA, such as those controls relevant to preparing performance information and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Our internal control testing was for the purpose of expressing an opinion on whether effective internal control over financial reporting was maintained, in all material respects. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness.

#### 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 which 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.

#### Opinion on Financial Statements

In our opinion, [entity’s] financial statements present fairly, in all material respects, [entity’s] financial position as of [September 30, 20XX, and 20XX], and its net cost of operations, changes in net position, and budgetary resources for the fiscal years then ended in accordance with U.S. generally accepted accounting principles.

**[Note: If applicable, insert emphasis-of-matter paragraph in accordance with AU-C 706 and include related heading. Conclude with “Our opinion on [entity’s] financial statements is not modified with respect to this matter.”]**

#### Opinion on Internal Control over Financial Reporting

In our opinion, [entity] maintained, in all material respects, effective internal control over financial reporting as of [September 30, 20XX], based on criteria established under FMFIA.

**[If applicable]** During our [20XX] audit, we identified deficiencies in [entity’s] internal control over financial reporting that we do not consider to be material weaknesses or significant



deficiencies.<sup>6</sup> Nonetheless, these deficiencies warrant **[entity]** management’s attention. We have communicated these matters to **[entity]** management and, where appropriate, will report on them separately.

#### Other Matters

##### Required Supplementary Information

U.S. generally accepted accounting principles issued by the Federal Accounting Standards Advisory Board (FASAB) require that the RSI be presented to supplement the financial statements. Although the RSI 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. We have applied certain limited procedures to the RSI in accordance with U.S. generally accepted government auditing standards, which consisted of inquiries of management about the methods of preparing the RSI and comparing the information for consistency with management’s responses to the auditor’s inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.

##### Other Information

**[Entity’s]** other information contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or the RSI. We read the other information included with the financial statements in order to identify material inconsistencies, if any, with the audited financial statements. Our audit was conducted for the purpose of forming an opinion on **[entity’s]** financial statements. We did not audit and do not express an opinion or provide any assurance on the other information.

#### **Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements**

In connection with our audits of **[entity’s]** financial statements, we tested compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements consistent with our auditor’s responsibility discussed below. We caution that noncompliance may occur and not be detected by these tests. We performed our tests of compliance in accordance with U.S. generally accepted government auditing standards.

##### Management’s Responsibility

**[Entity]** management is responsible for complying with laws, regulations, contracts, and grant agreements applicable to **[entity]**.

##### Auditor’s Responsibility

Our responsibility is to test compliance with selected provisions of laws, regulations, contracts, and grant agreements applicable to **[entity]** that have a direct effect on the determination of

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<sup>6</sup>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.

material amounts and disclosures in **[entity’s]** financial statements, and perform certain other limited procedures. Accordingly, we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to **[entity]**.

Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our tests for compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance for **[fiscal year 20XX]** that would be reportable under U.S. generally accepted government auditing standards. However, the objective of our tests was not to provide an opinion on compliance with laws, regulations, contracts, and grant agreements applicable to **[entity]**. Accordingly, we do not express such an opinion.

Intended Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

The purpose of this report is solely to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements, and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering compliance. Accordingly, this report on compliance with laws, regulations, contracts, and grant agreements is not suitable for any other purpose.

**Agency Comments [If applicable, add “and Our Evaluation.” Heading should be consistent with related wording on page 595A-2.]**

In commenting on a draft of this report, **[entity<sup>7</sup>]** .....The complete text of **[entity’s]** response is reprinted in appendix II.

**[Signature]**

**[Title]**

**[Date of auditor’s report]**

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<sup>7</sup>For GAO reports, only the agency name is cited in this section if the entity provides written comments. Do not include the name or title of the commenting official. If the entity provides an email or oral comments, the title of the commenting official is included. See Words@Work on the GAO intranet.

**Example 2 – Unmodified Opinion on Financial Statements, No Opinion on Effectiveness of Internal Control over Financial Reporting (No Material Weakness or Significant Deficiency Identified): No Reportable Noncompliance with Applicable Laws, Regulations, Contracts, and Grant Agreements**

[Auditor’s Address]

**Independent Auditor’s Report**

To [appropriate addressee]

In our audits of the fiscal years [20XX and 20XX] financial statements of [entity<sup>8</sup>], we found

- [entity’s] financial statements as of and for the fiscal years ended [September 30, 20XX, and 20XX], are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles;
- no material weaknesses in internal control over financial reporting based on the limited procedures we performed;<sup>9</sup> and
- no reportable noncompliance for [fiscal year 20XX] with provisions of applicable laws, regulations, contracts, and grant agreements we tested.

The following sections discuss in more detail (1) our report on the financial statements, which includes [if applicable insert “an emphasis-of-matter paragraph related to (include brief description), and”] required supplementary information (RSI)<sup>10</sup> and other information included with the financial statements;<sup>11</sup> (2) our report on internal control over financial reporting; (3) our report on compliance with laws, regulations, contracts, and grant agreements; and (4) agency comments [if applicable, add “and our evaluation” and revise related heading on page 595 A-11 for consistency].

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<sup>8</sup>This example assumes the acronym of the agency does not include the word “the” in front of it as part of its common usage (example: CFPB). If “the” is part of the common usage of the acronym (example: the FBI), apply throughout the example.

<sup>9</sup>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.

<sup>10</sup>The RSI consists of [insert description of the RSI, such as “Management’s Discussion and Analysis” and the “Combined Statement of Budgetary Resources”], which are included with the financial statements.

<sup>11</sup>Other information consists of information included with the financial statements, other than the RSI [if applicable] and the auditor’s report.

## Report on the Financial Statements

In accordance with [cite audit authority], we have audited [entity’s] financial statements. [Entity’s] financial statements comprise the balance sheets as of [September 30, 20XX, and 20XX]; the related statements of net cost [if included in the statement title, insert “of operations”], changes in net position, and budgetary resources for the fiscal years then ended; and the related notes to the financial statements.

We conducted our audits in accordance with U.S. generally accepted government auditing standards. We believe that the audit evidence we obtained is sufficient and appropriate to provide a basis for our audit opinions.

### Management’s Responsibility

[Entity] management is responsible for (1) the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; (2) preparing, measuring, and presenting the RSI in accordance with U.S. generally accepted accounting principles; (3) preparing and presenting other information included in documents containing the audited financial statements and auditor’s report, and ensuring the consistency of that information with the audited financial statements and the RSI; and (4) maintaining effective internal control over financial reporting, including 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.

### Auditor’s Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. U.S. generally accepted government auditing standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. We are also responsible for applying certain limited procedures to RSI and other information included with the financial statements.

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the auditor’s assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements 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. Accordingly, we express no such opinion. An audit of financial statements also involves evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. Our audits also included performing such other procedures as we considered necessary in the circumstances.

### Opinion on Financial Statements

In our opinion, [entity’s] financial statements present fairly, in all material respects, [entity’s] financial position as of [September 30, 20XX, and 20XX], and its net cost of operations, changes in net position, and budgetary resources for the fiscal years then ended in accordance with U.S. generally accepted accounting principles.

**[Note: If applicable, insert emphasis-of-matter paragraph in accordance with AU-C 706, and include related heading. Conclude with “Our opinion on [entity’s] financial statements is not modified with respect to this matter.”]**

Other Matters

Required Supplementary Information

U.S. generally accepted accounting principles issued by the Federal Accounting Standards Advisory Board (FASAB) require that the RSI be presented to supplement the financial statements. Although the RSI 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. We have applied certain limited procedures to the RSI in accordance with U.S. generally accepted government auditing standards, which consisted of inquiries of management about the methods of preparing the RSI and comparing the information for consistency with management’s responses to the auditor’s inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.

Other Information

**[Entity’s]** other information contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or the RSI. We read the other information included with the financial statements in order to identify material inconsistencies, if any, with the audited financial statements. Our audit was conducted for the purpose of forming an opinion on **[entity’s]** financial statements. We did not audit and do not express an opinion or provide any assurance on the other information.

**Report on Internal Control over Financial Reporting**

In connection with our audits of the **[entity’s]** financial statements, we considered the **[entity’s]** internal control over financial reporting, consistent with our auditor’s responsibility discussed below. We performed our procedures related to the **[entity’s]** internal control over financial reporting in accordance with U.S. generally accepted government auditing standards.

Management’s Responsibility

**[Entity]** management is responsible for maintaining effective internal control over financial reporting, including 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.

Auditor’s Responsibility

In planning and performing our audit of **[entity’s]** financial statements as of and for the year ended **[September 30, 20XX]**, in accordance with U.S. generally accepted government auditing standards, we considered the **[entity’s]** internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the **[entity’s]** internal control over financial reporting. Accordingly, we do not express an opinion on the **[entity’s]** internal control over financial reporting. We are required to report all deficiencies that are considered to be significant

deficiencies<sup>12</sup> or material weaknesses. We did not consider all internal controls relevant to operating objectives, such as those controls relevant to preparing performance information and ensuring efficient operations.

#### 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 which 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.

#### Results of Our Consideration of Internal Control over Financial Reporting

Our consideration of internal control was for the limited purpose described above, and was not designed to identify all deficiencies in internal control that might be material weaknesses and significant deficiencies or to express an opinion on the effectiveness of the [entity’s] internal control over financial reporting. Given these limitations, during our audit, we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

**[If applicable]** During our [20XX] audit, we identified deficiencies in [entity’s] internal control over financial reporting that we do not consider to be material weaknesses. Nonetheless, these deficiencies warrant [entity] management’s attention. We have communicated these matters to [entity] management and, where appropriate, will report on them separately.

#### Intended Purpose of Report on Internal Control over Financial Reporting

The purpose of this report is solely to describe the scope of our consideration of the [entity’s] internal control over financial reporting and the results of our procedures, and not to provide an opinion on the effectiveness of the [entity’s] internal control over financial reporting. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering internal control over financial reporting. Accordingly, this report on internal control over financial reporting is not suitable for any other purpose.

#### **Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements**

In connection with our audits of [entity’s] financial statements, we tested compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements consistent with our auditor’s responsibility discussed below. We caution that noncompliance may occur and not be detected by these tests. We performed our tests of compliance in accordance with U.S. generally accepted government auditing standards.

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<sup>12</sup>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.

Management’s Responsibility

**[Entity]** management is responsible for complying with laws, regulations, contracts, and grant agreements applicable to **[entity]**.

Auditor’s Responsibility

Our responsibility is to test compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements applicable to **[entity]** that have a direct effect on the determination of material amounts and disclosures in **[entity’s]** financial statements, and perform certain other limited procedures. Accordingly, we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to **[entity]**.

Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our tests for compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance for **[fiscal year 20XX]** that would be reportable under U.S. generally accepted government auditing standards. However, the objective of our tests was not to provide an opinion on compliance with laws, regulations, contracts, and grant agreements applicable to **[entity]**. Accordingly, we do not express such an opinion.

Intended Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

The purpose of this report is solely to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements, and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering compliance. Accordingly, this report on compliance with laws, regulations, contracts, and grant agreements is not suitable for any other purpose.

**Agency Comments [if applicable, add “and Our Evaluation.” Heading should be consistent with related wording on page 595 A-7.]**

In commenting on a draft of this report, **[entity<sup>13</sup>]** .....The complete text of **[entity’s]** response is reprinted in appendix II.

Signature

Title

Date of auditor’s report

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<sup>13</sup>For GAO reports, only the agency name is cited in this section if the entity provides written comments. Do not include the name or title of the commenting official. If the entity provides an email or oral comments, the title of the commenting official is included. See Words@Work on the GAO intranet.

## **595 B – Example of Reporting Material Weakness or Significant Deficiency on Internal Control over Financial Reporting**

Example 1 presents a report in which the auditor expresses an opinion on the effectiveness of internal control over financial reporting and a material weakness exists.

Example 2 presents a report in which the auditor expresses an opinion on the effectiveness of internal control over financial reporting and a significant deficiency exists.

In both examples, the auditor's opinion on the financial statements is unmodified, and no reportable noncompliance with applicable laws, regulations, contracts, and grant agreements is identified.

If the auditor is required to report whether an agency's systems comply substantially with the three FFMIA requirements, the example reports should be revised to include this item.



**Example 1 – Unmodified Opinion on Financial Statements, Material Weakness Exists in Internal Control over Financial Reporting; No Reportable Noncompliance with Applicable Laws, Regulations, Contracts, and Grant Agreements**

[Auditor’s Address]

**Independent Auditor’s Report**

To [appropriate addressee]

In our audits of the fiscal years [20XX and 20XX] financial statements of [entity<sup>1</sup>], we found

- [entity’s] financial statements as of and for the fiscal years ended [September 30, 20XX, and 20XX], are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles;
- [entity’s] internal control over financial reporting was not effective as of [September 30, 20XX]; and
- no reportable noncompliance for [fiscal year 20XX] with provisions of applicable laws, regulations, contracts, and grant agreements we tested.

The following sections discuss in more detail (1) our report on the financial statements and on internal control over financial reporting, which includes [if applicable insert “a matter of emphasis paragraph related to (include brief description), and”] required supplementary information (RSI)<sup>2</sup> and other information included with the financial statements;<sup>3</sup> (2) our report on compliance with laws, regulations, contracts, and grant agreements; and (3) agency comments [if applicable, add “and our evaluation” and revise related heading on page 595 B-7 for consistency].

**Report on the Financial Statements and on Internal Control over Financial Reporting**

In accordance with [cite audit authority], we have audited [entity’s] financial statements. [Entity’s] financial statements comprise the balance sheets as of [September 30, 20XX and 20XX]; the related statements of net cost [if included in statement title, insert “of operations”], changes in net position, and budgetary resources for the fiscal years then ended; and the related notes to the financial statements. We also have audited [entity’s] internal

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<sup>1</sup>This example assumes the acronym of the agency does not include the word “the” in front of it as part of its common usage (example: CFPB). If “the” is part of the common usage of the acronym (example: the FBI), apply throughout the example.

<sup>2</sup>The RSI consists of [insert description of the RSI, such as “Management’s Discussion and Analysis” and the “Combined Statement of Budgetary Resources”], which are included with the financial statements.

<sup>3</sup>Other information consists of information included with the financial statements, other than the RSI [if applicable] and the auditor’s report.

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## Reporting Phase

### 595 B – Example of Reporting Material Weakness or Significant Deficiency on Internal Control over Financial Reporting

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control over financial reporting as of **[September 30, 20XX]**, based on criteria established under 31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act (FMFIA).

We conducted our audits in accordance with U.S. generally accepted government auditing standards. We believe that the audit evidence we obtained is sufficient and appropriate to provide a basis for our audit opinions.

#### Management's Responsibility

**[Entity]** management is responsible for (1) the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; (2) preparing, measuring, and presenting the RSI in accordance with U.S. generally accepted accounting principles; (3) preparing and presenting other information included in documents containing the audited financial statements and auditor's report, and ensuring the consistency of that information with the audited financial statements and the RSI; (4) maintaining effective internal control over financial reporting, including 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; (5) evaluating the effectiveness of internal control over financial reporting based on the criteria established under FMFIA; and (6) its assessment about the effectiveness of internal control over financial reporting as of **[September 30, 20XX]**, included in the accompanying Management's Report on Internal Control over<sup>4</sup> Financial Reporting **[or other title of management's report]** in appendix I.

#### Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements and an opinion on **[entity's]** internal control over financial reporting based on our audits. U.S. generally accepted government auditing standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement, and whether effective internal control over financial reporting was maintained in all material respects. We are also responsible for applying certain limited procedures to RSI and other information included with the financial statements.

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the auditor's assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of financial statements also involves evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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<sup>4</sup>Note: GAO does not capitalize the "o" in "over" in "internal control over financial reporting" when used in a heading or title. However, when referring to the title of management's report included with the auditor's report, the wording and capitalization should be consistent with management's presentation.

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## Reporting Phase

### 595 B – Example of Reporting Material Weakness or Significant Deficiency on Internal Control over Financial Reporting

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An audit of internal control over financial reporting involves performing procedures to obtain evidence about whether a material weakness exists.<sup>5</sup> The procedures selected depend on the auditor's judgment, including the assessment of the risk that a material weakness exists. An audit of internal control over financial reporting also includes obtaining an understanding of internal control over financial reporting, and evaluating and testing the design and operating effectiveness of internal control over financial reporting based on the assessed risk. Our audit of internal control also considered [entity's] process for evaluating and reporting on internal control over financial reporting based on criteria established under FMFIA. Our audits also included performing such other procedures as we considered necessary in the circumstances.

We did not evaluate all internal controls relevant to operating objectives as broadly established under FMFIA, such as those controls relevant to preparing performance information and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Our internal control testing was for the purpose of expressing an opinion on whether effective internal control over financial reporting was maintained, in all material respects. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness.

#### 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 which 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.

#### Opinion on Financial Statements

In our opinion, [entity's] financial statements present fairly, in all material respects, [entity's] financial position as of [September 30, 20XX, and 20XX], and its net cost of operations, changes in net position, and budgetary resources for the fiscal years then ended in accordance with U.S. generally accepted accounting principles.

However, misstatements may nevertheless occur in unaudited financial information reported internally or externally by [entity] as a result of the internal control deficiencies described in this report.

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<sup>5</sup>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.

**[Note: If applicable, insert matter of emphasis paragraph in accordance with AU-C 706 and include related heading. Conclude with “Our opinion on [entity’s] financial statements is not modified with respect to this matter.”]**

Opinion on Internal Control over Financial Reporting

In our opinion, because of a material weakness in internal control over **[briefly name the deficiency]**, **[entity]** did not maintain, in all material respects, effective internal control over financial reporting as of **[September 30, 20XX]**, based on criteria established under FMFIA.

**[Customize as appropriate]** Although **[entity]** had a material weakness in internal control over **[briefly name the deficiency]**, **[which existed in prior years, (if applicable)]** **[entity]** made any necessary adjustments to its records and was therefore able to prepare financial statements that were fairly presented in all material respects for fiscal year **[20XX]**. This material weakness, which is discussed in more detail below, is also disclosed by **[entity]** in its fiscal year **[20XX]** (1) FMFIA assurance statement and (2) Management’s Report on Internal Control over Financial Reporting. We considered this material weakness in determining the nature, timing, and extent of our audit procedures on **[entity’s]** fiscal year **[20XX]** financial statements.

**[If applicable]** In addition to the material weakness in internal control over **[insert description of material weakness from above]**, we also identified other deficiencies in **[entity’s]** internal control over financial reporting that we do not consider to be material weaknesses or significant deficiencies.<sup>6</sup> Nonetheless, these deficiencies warrant **[entity]** management’s attention. We have communicated these matters to **[entity]** management and, where appropriate, will report on them separately.<sup>7</sup>

Material Weakness in Internal Control over **[briefly name the deficiency]**

**[Describe material weakness, including any progress or changes in the internal control deficiencies identified if they were previously reported.]**

Other Matters

Required Supplementary Information

U.S. generally accepted accounting principles issued by the Federal Accounting Standards Advisory Board (FASAB) require that the RSI be presented to supplement the financial statements. Although the RSI 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. We have applied certain limited procedures to the RSI in accordance with U.S. generally accepted government auditing standards, which consisted of inquiries of management about the methods of preparing the RSI and comparing the information for consistency with management’s responses to the auditor’s inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report

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<sup>6</sup>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.

<sup>7</sup>If applicable, consider adding the following sentence to the beginning of the paragraph “We will be reporting additional details concerning this material weakness separately to **[entity]** management, along with recommendations for corrective actions.”

omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.

#### Other Information

**[Entity's]** other information contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or the RSI. We read the other information included with the financial statements in order to identify material inconsistencies, if any, with the audited financial statements. Our audit was conducted for the purpose of forming an opinion on **[entity's]** financial statements. We did not audit and do not express an opinion or provide any assurance on the other information.

### **Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements**

In connection with our audits of **[entity's]** financial statements, we tested compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements consistent with our auditor's responsibility discussed below. We caution that noncompliance may occur and not be detected by these tests. We performed our tests of compliance in accordance with U.S. generally accepted government auditing standards.

#### Management's Responsibility

**[Entity]** management is responsible for complying with laws, regulations, contracts, and grant agreements applicable to **[entity]**.

#### Auditor's Responsibility

Our responsibility is to test 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 and disclosures in **[entity's]** financial statements, and perform certain other limited procedures. Accordingly, we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to **[entity]**.

#### Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our tests for compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance for **[fiscal year 20XX]** that would be reportable under U.S. generally accepted government auditing standards. However, the objective of our tests was not to provide an opinion on compliance with laws, regulations, contracts, and grant agreements applicable to **[entity]**. Accordingly, we do not express such an opinion.

#### Intended Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

The purpose of this report is solely to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements, and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering compliance. Accordingly, this report on compliance with laws, regulations, contracts, and grant agreements is not suitable for any other purpose.

**Agency Comments [If applicable, add “and Our Evaluation.” Heading should be consistent with related wording on page 595 B-2.]**

In commenting on a draft of this report, [entity<sup>8</sup>] .....The complete text of [entity’s] response is reprinted in appendix II.

**[Signature]**

**[Title]**

**[Date of auditor’s report]**

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<sup>8</sup>For GAO reports, only the agency name is cited in this section if the entity provides written comments. Do not include the name or title of the commenting official. If the entity provides an email or oral comments, the title of the commenting official is included. See Words@Work on the GAO intranet.

**Example 2 – Unmodified Opinion on Financial Statements, Unmodified Opinion on Internal Control over Financial Reporting, but Significant Deficiency Exists (No Material Weaknesses); No Reportable Noncompliance with Applicable Laws, Regulations, Contracts, and Grant Agreements**

[Auditor's Address]

**Independent Auditor's Report**

To [appropriate addressee]

In our audits of the fiscal years [20XX and 20XX] financial statements of [entity<sup>9</sup>], we found

- [entity's] financial statements as of and for the fiscal years ended [September 30, 20XX, and 20XX], are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles;
- although internal controls could be improved, [entity] maintained, in all material respects, effective internal control over financial reporting as of [September 30, 20XX]; and
- no reportable noncompliance for [fiscal year 20XX] with provisions of applicable laws, regulations, contracts, and grant agreements we tested.

The following sections discuss in more detail (1) our report on the financial statements and on internal control over financial reporting, which includes [if applicable insert "a matter of emphasis paragraph related to (include brief description), and"] required supplementary information (RSI)<sup>10</sup> and other information included with the financial statements;<sup>11</sup> (2) our report on compliance with laws, regulations, contracts, and grant agreements; and (3) agency comments [if applicable, add "and our evaluation" and revise related heading on page 595 B-13 for consistency].

**Report on the Financial Statements and on Internal Control over Financial Reporting**

In accordance with [cite audit authority], we have audited [entity's] financial statements. [Entity's] financial statements comprise the balance sheets as of [September 30, 20XX and 20XX]; the related statements of net cost [if included in statement title, insert "of operations"], changes in net position, and budgetary resources for the fiscal years then ended;

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<sup>9</sup>This example assumes the acronym of the agency does not include the word "the" in front of it as part of its common usage (example: CFPB). If "the" is part of the common usage of the acronym (example: the FBI), apply throughout the example.

<sup>10</sup>The RSI consists of [insert description of the RSI, such as "Management's Discussion and Analysis" and the "Combined Statement of Budgetary Resources"], which are included with the financial statements.

<sup>11</sup>Other information consists of information included with the financial statements, other than the RSI [if applicable] and the auditor's report.

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## Reporting Phase

### 595 B – Example of Reporting Material Weakness or Significant Deficiency on Internal Control over Financial Reporting

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and the related notes to the financial statements. We also have audited **[entity's]** internal control over financial reporting as of **[September 30, 20XX]**, based on criteria established under 31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act (FMFIA).

We conducted our audits in accordance with U.S. generally accepted government auditing standards. We believe that the audit evidence we obtained is sufficient and appropriate to provide a basis for our audit opinions.

#### Management's Responsibility

**[Entity]** management is responsible for (1) the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; (2) preparing, measuring, and presenting the RSI in accordance with U.S. generally accepted accounting principles; (3) preparing and presenting other information included in documents containing the audited financial statements and auditor's report, and ensuring the consistency of that information with the audited financial statements and the RSI; (4) maintaining effective internal control over financial reporting, including 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; (5) evaluating the effectiveness of internal control over financial reporting based on the criteria established under FMFIA; and (6) its assessment about the effectiveness of internal control over financial reporting as of **[September 30, 20XX]**, included in the accompanying Management's Report on Internal Control over<sup>12</sup> Financial Reporting **[or other title of management's report]** in appendix I.

#### Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements and an opinion on **[entity's]** internal control over financial reporting based on our audits. U.S. generally accepted government auditing standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement, and whether effective internal control over financial reporting was maintained in all material respects. We are also responsible for applying certain limited procedures to RSI and other information included with the financial statements.

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the auditor's assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of financial statements also involves evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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<sup>12</sup>Note: GAO does not capitalize the "o" in "over" in the phrase "internal control over financial reporting" when used in a heading or title. However, when referring to the title of management's report included with the auditor's report, the wording and capitalization should be consistent with management's presentation.



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## Reporting Phase

### 595 B – Example of Reporting Material Weakness or Significant Deficiency on Internal Control over Financial Reporting

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An audit of internal control over financial reporting involves performing procedures to obtain evidence about whether a material weakness exists.<sup>13</sup> The procedures selected depend on the auditor's judgment, including the assessment of the risk that a material weakness exists. An audit of internal control over financial reporting also includes obtaining an understanding of internal control over financial reporting, and evaluating and testing the design and operating effectiveness of internal control over financial reporting based on the assessed risk. Our audit of internal control also considered [entity's] process for evaluating and reporting on internal control over financial reporting based on criteria established under FMFIA. Our audits also included performing such other procedures as we considered necessary in the circumstances.

We did not evaluate all internal controls relevant to operating objectives as broadly established under FMFIA, such as those controls relevant to preparing performance information and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Our internal control testing was for the purpose of expressing an opinion on whether effective internal control over financial reporting was maintained, in all material respects. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness.

#### 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 which 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.

#### Opinion on Financial Statements

In our opinion, [entity's] financial statements present fairly, in all material respects, [entity's] financial position as of [September 30, 20XX, and 20XX], and its net cost of operations, changes in net position, and budgetary resources for the fiscal years then ended in accordance with U.S. generally accepted accounting principles.

**[Note: If applicable, insert matter of emphasis paragraph in accordance with AU-C 706 and include related heading. Conclude with "Our opinion on [entity's] financial statements is not modified with respect to this matter."]**

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<sup>13</sup>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.

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## Reporting Phase

### 595 B – Example of Reporting Material Weakness or Significant Deficiency on Internal Control over Financial Reporting

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#### Opinion on Internal Control over Financial Reporting

In our opinion, although certain internal controls could be improved, [entity] maintained, in all material respects, effective internal control over financial reporting as of [September 30, 20XX], based on criteria established under FMFIA. As discussed below in more detail, our [20XX] audit identified deficiencies in [entity's] controls over [describe account or process where significant deficiency identified, for example, accounts receivable process] that collectively represent a significant deficiency in [entity's] internal control over financial reporting.<sup>14</sup> We considered this significant deficiency in determining the nature, timing, and extent of our audit procedures on [entity's] fiscal year [20XX] financial statements.

Although the significant deficiency in internal control did not affect our opinion on [entity's] fiscal year [20XX] financial statements, misstatements may occur in unaudited financial information reported internally and externally by [entity] because of this significant deficiency.

**[If applicable]** In addition to the significant deficiency in internal control over [insert description of significant deficiency from above], we also identified other deficiencies in [entity's] internal control over financial reporting that we do not consider to be material weaknesses or significant deficiencies. Nonetheless, these deficiencies warrant [entity] management's attention. We have communicated these matters to [entity] management and, where appropriate, will report on them separately.<sup>15</sup>

#### Significant Deficiency in Internal Control over [briefly name the deficiency]

**[Describe significant deficiency, including any progress or changes in the internal control deficiencies identified if they were previously reported.]**

#### Other Matters

##### Required Supplementary Information

U.S. generally accepted accounting principles issued by the Federal Accounting Standards Advisory Board (FASAB) require that the RSI be presented to supplement the financial statements. Although the RSI 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. We have applied certain limited procedures to the RSI in accordance with U.S. generally accepted government auditing standards, which consisted of inquiries of management about the methods of preparing the RSI and comparing the information for consistency with management's responses to the auditor's inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.

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<sup>14</sup>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.

<sup>15</sup>If applicable, consider adding the following sentence to the beginning of the paragraph "We will be reporting additional details concerning this significant deficiency separately to [entity] management, along with recommendations for corrective actions."

Other Information

**[Entity’s]** other information contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or the RSI. We read the other information included with the financial statements in order to identify material inconsistencies, if any, with the audited financial statements. Our audit was conducted for the purpose of forming an opinion on **[entity’s]** financial statements. We did not audit and do not express an opinion or provide any assurance on the other information.

**Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements**

In connection with our audits of **[entity’s]** financial statements, we tested compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements consistent with our auditor’s responsibility discussed below. We caution that noncompliance may occur and not be detected by these tests. We performed our tests of compliance in accordance with U.S. generally accepted government auditing standards.

Management’s Responsibility

**[Entity]** management is responsible for complying with laws, regulations, contracts, and grant agreements applicable to **[entity]**.

Auditor’s Responsibility

Our responsibility is to test 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 and disclosures in **[entity’s]** financial statements, and perform certain other limited procedures. Accordingly, we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to **[entity]**.

Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our tests for compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance for **[fiscal year 20XX]** that would be reportable under U.S. generally accepted government auditing standards. However, the objective of our tests was not to provide an opinion on compliance with laws, regulations, contracts, and grant agreements applicable to **[entity]**. Accordingly, we do not express such an opinion.

Intended Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

The purpose of this report is solely to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements, and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering compliance. Accordingly, this report on compliance with laws, regulations, contracts, and grant agreements is not suitable for any other purpose.

**Agency Comments [If applicable, add “and Our Evaluation.” Heading should be consistent with related wording on page 595B-8.]**

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Reporting Phase  
595 B – Example of Reporting Material Weakness or Significant Deficiency on Internal Control  
over Financial Reporting

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In commenting on a draft of this report, **[entity<sup>16</sup>]** .....The complete text of **[entity's]** response is reprinted in appendix II.

**[Signature]**

**[Title]**

**[Date of auditor's report]**

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<sup>16</sup>For GAO reports, only the agency name is cited in this section if the entity provides written comments. Do not include the name or title of the commenting official. If the entity provides an email or oral comments, the title of the commenting official is included. See Words@Work on the GAO intranet.

## **595 C – Uncorrected Misstatements and Adjusting Entries**

- .01 As discussed in FAM 540.04, the auditor should accumulate factual, judgmental, and projected misstatements that the auditor identified during the audit but have not yet corrected by the entity. The auditor may do this on a Schedule of Uncorrected Misstatements that includes related adjusting entries (see FAM 595 C, example 1). Because the entity is responsible for its financial statements, as discussed in FAM 540.06 through .07, management has to decide which misstatements to correct in the financial statements and which amounts will remain uncorrected misstatements. The auditor should communicate misstatements to those charged with governance.

### **Schedule of Uncorrected Misstatements (before Discussion with Management) (FAM 595 C – Example 1)**

- .02 The auditor should include the effect of uncorrected misstatements on the entity's financial statements and provide the related adjusting entries to entity management. Because this information follows the entity's financial statements, the specific line items may differ for each entity. The auditor should list all uncorrected misstatements other than those below a clearly trivial amount (see FAM 540.04).
- .03 As discussed in FAM 540.05, the auditor should quantify and evaluate misstatements under both the rollover and iron curtain approaches. Subsequently, the auditor generally should propose an adjusting entry when either approach results in quantifying a misstatement that is above clearly trivial, after considering all relevant quantitative and qualitative factors.
- .04 The auditor should also include the effect of uncorrected misstatements from the prior year on the current year's financial statements (the carryover effect) or note that there were no prior-year misstatements.
- .05 Typical information related to adjusting entries information would include the following:
- a. Reference to an adjustment number or documentation reference.
  - b. Whether the misstatement is factual, judgmental, or projected.
  - c. Whether the misstatement is the carryover effect from a prior year (PY) or a misstatement arising in the current year (CY).
  - d. Description of the adjustment.
  - e. Indication of whether each account affected is a federal intragovernmental (F) or a nonfederal public account (N).
  - f. SGL account number and account description.
  - g. Amount of the debit and credit.
  - h. Line items affected in the entity's financial statements. (For entities required to submit misstatements for use in the preparation and audit of the U.S. government's consolidated financial statements (CFS), the auditor generally should indicate the CFS line item affected.)

## **Discuss Uncorrected Misstatements with Management and Those Charged with Governance**

- .06 The auditor should communicate factual, judgmental, and projected misstatements identified during the audit to the appropriate level of management and those charged with governance, as required by AU-C 450 and AU-C 260. The auditor should request that management correct all misstatements, as discussed in FAM 540.06 through .07. If management investigates and challenges assumptions or methods used in developing an estimate for judgmental and projected misstatements, the auditor should reevaluate the misstatement and determine whether to perform additional audit procedures. The auditor should document discussions with management on misstatements and any additional audit procedures performed.
- .07 The auditor also may communicate to those charged with governance other corrected immaterial misstatements, such as frequently recurring immaterial misstatements that may indicate a particular bias in the preparation of the financial statements. An example would be recurring cutoff errors for liabilities at year-end.
- .08 If there are a large number of small uncorrected misstatements, the auditor may communicate to those charged with governance the number and overall monetary effect of the misstatements, rather than the details of each misstatement.
- .09 The auditor should discuss with those charged with governance the implications of management's failure to correct factual, judgmental, and projected misstatements, considering qualitative as well as quantitative considerations, including possible implications in relation to future financial statements.

## **Schedule of Uncorrected Misstatements (after Discussion with Management) (FAM 595 C – Example 2)**

- .10 If management corrects one or more of the identified misstatements to the financial statements, the auditor should use the Schedule of Uncorrected Misstatements (before Discussion with Management) – Example 1 to create a new Summary of Uncorrected Misstatements (after Discussion with Management) for any uncorrected misstatements, as indicated in example 2 of this FAM section. The example summary includes a last column of final account balances to assist the auditor in calculating, evaluating, and concluding the effect of uncorrected misstatements on the final financial statements. In example 2, management has declined to correct misstatements 1 through 5 in the financial statements as management has determined them immaterial.
- .11 The auditor generally should transfer any corrected misstatement to a Summary of Misstatements Corrected as indicated in example 3 of this FAM section. In example 3, management has agreed to correct misstatement 6 in the financial statements as management has determined it to be material.
- .12 The auditor should attach the Summary of Uncorrected Misstatements (from example 2) without the auditor's calculations, evaluation, and conclusion (or a listing of uncorrected misstatements if the number and amount of the misstatements are insignificant) to the management representation letter, as discussed in FAM 1001.

### **Final Evaluation**

- .13 The auditor should evaluate the effect of the uncorrected misstatements and determine whether the financial statements taken as a whole are materially misstated from a quantitative or qualitative viewpoint (FAM 540).
- .14 The auditor should also conclude (in consultation with the reviewer, as discussed in FAM 540.04 and FAM 545) on the adequacy of the scope of procedures performed in light of the total uncorrected misstatements identified above.

## Example 1 – Schedule of Uncorrected Misstatements (before Discussion with Management), Including a Prior Period Misstatement

(This schedule lists the uncorrected misstatements and the effects identified by the auditor. See FAM 595 C.02 through .05. In this example, one of the proposed adjustments relates to an expense cut-off error in which \$200 of expenses related to the following year were recorded in the current year, thereby overstating other liabilities by \$200 at the end of the current year. In addition, a similar cut-off error existed at the end of the prior year, in which \$300 of expenses related to the current year were included in the prior year. For the purpose of evaluating misstatements under the rollover approach in the current year, the entity quantifies the misstatement as a \$200 overstatement of expenses, offset by the effect of the reversal of the \$300 understatement of expenses included in the prior year that should have been incurred in the current year. The schedule also includes the misstatements and related adjustment quantified under the iron curtain approach. The adjustment consists of a \$300 debit to beginning net position and a \$300 credit to operating expenses to reverse the effects of prior year misstatements recorded under the rollover approach, resulting in a \$200 overstatement of other liabilities and total net cost as of the end of the current year.)

| (Dollars in thousands)<br>(1)           | Adjustment<br>number<br>(2) | Factual,<br>judgmental, or<br>projected<br>misstatement<br>(3) | Line item<br>balance<br>(4)<br><br>Debit/(Credit) | Total misstatements<br>(5) |          |                       | Effect of prior<br>year<br>misstatements<br>(6)<br><br>Debit/(Credit) | Adjusted line item<br>balance – effect of<br>misstatements<br>originating in the<br>current year<br>(7) = (4) + (5) + (6)<br><br>Debit/(Credit) | Misstatement<br>as percentage<br>of reported<br>line item -<br>effect of<br>misstatements<br>originating in<br>the current<br>year<br>(8) | Adjustments<br>for the effect<br>of<br>misstatements<br>on the<br>balance sheet<br>as of the end<br>of the current<br>year<br>(9) | Adjusted line<br>item balance –<br>effect of<br>misstatements<br>on the balance<br>sheet as of the<br>end of the<br>current year<br>(10) = (7) + (9)<br><br>Debit/(Credit) | Misstatement<br>as percentage<br>of reported line<br>item - effect of<br>misstatements<br>as of the end<br>of the current<br>year<br>(11) |
|---|-----------------------------|--|---|----------------------------|----------|-----------------------|---|---|---|---|--|---|
|   |                             |  |   | Debit                      | (Credit) | Net<br>Debit/(Credit) |   |   |   |   |  |   |
| <u>Balance Sheet</u> <sup>1</sup>       |                             |  |   |                            |          |                       |   |   |   |   |  |   |
| <u>Assets</u>                           |                             |  |   |                            |          |                       |   |   |   |   |  |   |
| Fund balance with Treasury              | 5                           | F  | 50,000  |                            | (10,000) | (10,000)              |   | 40,000  | -20.00%   |   | 40,000   | -20.00%   |
| Accounts receivable, net                | 3                           | F  | 125   |                            | (25)     | (105)                 |   | 20  | -84.00%   |   | 20   | -84.00%   |
|   | 4                           | P  |   |                            | (80)     |                       |   |   |   |   |  |   |
| Loans receivable, net                   |                             |  | 1,000   |                            |          |                       |   | 1,000   | 0.00%   |   | 1,000  | 0.00%   |
| PPE, net                                |                             |  | 40,000  |                            |          |                       |   | 40,000  | 0.00%   |   | 40,000   | 0.00%   |
| Inventory                               |                             |  | 8,000   |                            |          |                       |   | 8,000   | 0.00%   |   | 8,000  | 0.00%   |
| Total assets                            |                             |  | 99,125  |                            | (10,105) | (10,105)              |   | 89,020  |   |   | 89,020   |   |
| <u>Liabilities</u>                      |                             |  |   |                            |          |                       |   |   |   |   |  |   |
| Accounts payable -<br>nonfederal public | 1                           | J  | (2,000)   |                            | (230)    | (230)                 |   | (2,230)   | 11.50%  |   | (2,230)  | 11.50%  |
| Other liabilities                       | 2                           | F  | (5,250)   | 200                        |          | 200                   |   | (5,050)   | -3.81%  |   | (5,050)  | -3.81%  |

<sup>1</sup>As needed, create additional schedules for other financial statements that have adjustments.



Reporting Phase  
595 C – Uncorrected Misstatements and Adjusting Entries

| (Dollars in thousands)<br>(1)         | Adjustment<br>number<br>(2) | Factual,<br>judgmental, or<br>projected<br>misstatement<br>(3) | Line item<br>balance<br>(4) | Total misstatements<br>(5) |          |                       | Effect of prior<br>year<br>misstatements<br>(6) | Adjusted line item<br>balance – effect of<br>misstatements<br>originating in the<br>current year<br>(7) = (4) + (5) + (6) | Misstatement<br>as percentage<br>of reported<br>line item -<br>effect of<br>misstatements<br>originating in<br>the current<br>year<br>(8) | Adjustments<br>for the effect<br>of<br>misstatements<br>on the<br>balance sheet<br>as of the end<br>of the current<br>year<br>(9) | Adjusted line<br>item balance –<br>effect of<br>misstatements<br>on the balance<br>sheet as of the<br>end of the<br>current year<br>(10) = (7) + (9) | Misstatement<br>as percentage<br>of reported line<br>item - effect of<br>misstatements<br>as of the end<br>of the current<br>year<br>(11) |
|---------------------------------------|-----------------------------|--|-----------------------------|----------------------------|----------|-----------------------|---|---|---|---|--|---|
|                                       |                             |  | Debit/(Credit)              | Debit                      | (Credit) | Net<br>Debit/(Credit) | Debit/(Credit)                                  | Debit/(Credit)  |   |   | Debit/(Credit)   |   |
| Total liabilities                     |                             |  | (7,250)                     | 200                        | (230)    | (30)                  |   | (7,280)   |   |   | (7,280)  |   |
| <u>Net Position</u>                   |                             |  |                             |                            |          |                       |   |   |   |   |  |   |
| Beginning Net Position                |                             |  | (104,675)                   |                            |          |                       | (300)   | (104,975)   | 0.29%   | 300   | (104,675)  | 0.00%   |
| Net current year (surplus)<br>deficit | 1                           | J  | 12,800                      | 230                        |          | 10,135                |   | 23,235  | 81.52%  | (300)   | 22,935   | 79.18%  |
|                                       | 2                           | F  |                             |                            | (200)    |                       | 300   |   |   |   |  |   |
|                                       | 3                           | F  |                             | 25                         |          |                       |   |   |   |   |  |   |
|                                       | 4                           | P  |                             | 80                         |          |                       |   |   |   |   |  |   |
|                                       | 5                           | F  |                             | 10,000                     |          |                       |   |   |   |   |  |   |
| Total net position                    |                             |  | (91,875)                    | 10,335                     | (200)    | 10,135                |   | (81,740)  |   |   | (81,740)   |   |
| Total liabilities and net<br>position |                             |  | (99,125)                    | 10,510                     | (430)    | 10,105                |   | (89,020)  |   |   | (89,020)   |   |
| Total uncorrected<br>misstatements    |                             |  |                             | 10,535                     | (10,535) |                       | 300   |   |   | 300   |  |   |
| <u>Statement of Net Cost</u>          |                             |  |                             |                            |          |                       |   |   |   |   |  |   |
| Net cost of operations:               |                             |  |                             |                            |          |                       |   |   |   |   |  |   |
| Program A:                            |                             |  |                             |                            |          |                       |   |   |   |   |  |   |
| Gross cost - nonfederal<br>public     | 1                           | J  | 19,800                      | 230                        |          | 30                    |   | 20,130  | 1.67%   | (300)   | 19,830   | 0.15%   |
|                                       | 2                           | F  |                             |                            | (200)    |                       | 300   |   |   |   |  |   |
| Less: earned revenue                  |                             |  | (23,000)                    |                            |          |                       |   | (23,000)  | 0.00%   |   | (23,000)   | 0.00%   |
| Net cost Program A                    |                             |  | (3,200)                     | 230                        | (200)    | 30                    | 300   | (2,870)   | -10.31%   | (300)   | (3,170)  | -0.94%  |
| Program B:                            |                             |  |                             |                            |          |                       |   |   |   |   |  |   |
| Gross cost - nonfederal<br>public     |                             |  | 31,000                      |                            |          |                       |   | 31,000  | 0.00%   |   | 31,000   | 0.00%   |
| Gross cost -<br>intragovernmental     | 3                           | F  | 500                         | 25                         |          | 105                   |   | 605   | 21.00%  |   | 605  | 21.00%  |
|                                       | 4                           | P  |                             | 80                         |          |                       |   |   |   |   |  |   |

Reporting Phase  
595 C – Uncorrected Misstatements and Adjusting Entries

| (Dollars in thousands)<br>(1) | Adjustment<br>number<br>(2) | Factual,<br>judgmental, or<br>projected<br>misstatement<br>(3) | Line item<br>balance<br>(4)<br><br>Debit/(Credit) | Total misstatements<br>(5) |          |                       | Effect of prior<br>year<br>misstatements<br>(6)<br><br>Debit/(Credit) | Adjusted line item<br>balance – effect of<br>misstatements<br>originating in the<br>current year<br>(7) = (4) + (5) + (6)<br><br>Debit/(Credit) | Misstatement<br>as percentage<br>of reported<br>line item -<br>effect of<br>misstatements<br>originating in<br>the current<br>year<br>(8) | Adjustments<br>for the effect<br>of<br>misstatements<br>on the<br>balance sheet<br>as of the end<br>of the current<br>year<br>(9) | Adjusted line<br>item balance –<br>effect of<br>misstatements<br>on the balance<br>sheet as of the<br>end of the<br>current year<br>(10) = (7) + (9)<br><br>Debit/(Credit) | Misstatement<br>as percentage<br>of reported line<br>item - effect of<br>misstatements<br>as of the end<br>of the current<br>year<br>(11) |
|-------------------------------|-----------------------------|--|---|----------------------------|----------|-----------------------|---|---|---|---|--|---|
|                               |                             |  |   | Debit                      | (Credit) | Net<br>Debit/(Credit) |   |   |   |   |  |   |
| Less: earned revenue          | 5                           | F  | (15,500)  | 10,000                     |          | 10,000                |   | (5,500)   | -64.52%   |   | (5,500)  | -64.52%   |
| Net cost Program B            |                             |  | 16,000  | 10,105                     |          | 10,105                |   | 26,105  | 63.16%  |   | 26,105   | 63.16%  |
| Total net cost of operations  |                             |  | 12,800  | 10,335                     | (200)    | 10,135                | 300   | 23,235  | 81.52%  | (300)   | 22,935   | 79.18%  |

Note: The line items presented mirror those in the entity's financial statements. Also, for illustration purposes, only the balance sheet and net cost misstatements are presented. When presented to management, the effect on all entity financial statements is presented

Legend:

Total misstatements – All misstatements arising in the current year are included in this column. This does not include misstatements arising in prior years (e.g., included in the prior year Summary of Uncorrected Misstatements or misstatements identified in the current year that should be included in the prior year Summary of Uncorrected Misstatements.) Misstatements in this column correspond to adjusting entries included below.

Effect of prior year misstatements – Current year misstatements as a result of misstatements arising in prior years (e.g., reversal of items included in the prior year Summary of Uncorrected Misstatements are included in this column.) Misstatements in this column correspond to adjusting entries included below.

Adjusted line item balance – effect of misstatements originating in the current year – This column shows the adjusted line item balance after accounting for the effect of total misstatements originating in the current year.

Misstatement as percentage of reported line item (effect of misstatements originating in the current year) – The effect of misstatements originating in the current year as a percentage of the reported line item balance is displayed in this column to help assess the materiality of the misstatement on each line item.

Adjustments for the effect of misstatements on the balance sheet as of the end of the current year – This column includes any adjustments to misstatements as a result of switching approaches from quantifying misstatements originating in the current year to quantifying all misstatements as of the end of the current year, regardless of the period in which the misstatement arose. This column can include reversals of misstatements that were included when only considering the effect of misstatements originating in the current year. Misstatements in this column correspond to adjusting entries included below.

Adjusted line item balance - effect of misstatements on the balance sheet as of the end of the current year – This column shows the adjusted line item balance after accounting for any adjustments needed to consider the effect of all misstatements as of the end of the current year.

Misstatement as percentage of reported line item (effect of misstatements as of the end of the current year) - Misstatements as of the end of the current year are displayed in this column as a percentage of the reported line item balance to help assess the materiality of the misstatement on each line item.

### Example 1 – Adjusting Entries to Correct Misstatements (before Discussion with Management)

| Adj.<br>#  | Management will record?              |            |                    |   |   |                 |   |          |                        |          |   |
|--|--------------------------------------|------------|--------------------|---|---|-----------------|---|----------|------------------------|----------|---|
|  | Factual, judgmental or projected?    |            |                    |   | Federal governmental (F) or nonfederal public (N) |                 |   |          | (Dollars in thousands) |          | Corresponding U.S. government's CFS line item             |
|  | Prior year (PY) or current year (CY) |            | SGL account number |   |   |                 |   |          |                        |          |   |
|  |                                      |            |                    |   | Description                                       | SGL Description | Debit   | Credit   |                        |          |   |
| 1  |                                      | Judgmental | CY                 | To accrue accounts payable for Program A.   | N<br>N  | 6100<br>2110    | Operating expenses – Program A<br>Accounts payable                | \$230    |                        | \$230    |   |
| 2  |                                      | Factual    | CY                 | To decrease operating expenses arising in the current year from the current year cut-off error.   | N<br>N  | 2990<br>6100    | Other liabilities<br>Operating expenses – Program A               | \$200    |                        | \$200    | Other liabilities<br>Gross costs                          |
|  |                                      | Factual    | PY                 | To increase current year operating expenses arising from the prior year cut-off error (from prior year Summary of Uncorrected Misstatements).   | N<br>N  | 6100<br>3000    | Operating expenses – Program A<br>Beginning net position          | \$300    |                        | \$300    | Gross costs<br>Net Position, beginning of period          |
| 3  |                                      | Factual    | CY                 | To increase current year loan bad debt expense in Program B. [Actual error amount of an intragovernmental sample item.]   | F<br>F  | 6720<br>1319    | Bad debt expense – Program B<br>Allowance for accounts receivable | \$25     |                        | \$25     | Intragovernmental amounts are eliminated in consolidation |
| 4  |                                      | Projected  | CY                 | To increase current year loan bad debt expense in Program B. [Additional projected misstatement as a result of actual error amount of sample item from Adj #3 above projected to the population. Total projected misstatement of \$105 less \$25 actual misstatement] | F<br>F  | 6720<br>1319    | Bad debt expense – Program B<br>Allowance for accounts receivable | \$80     |                        | \$80     | Intragovernmental amounts are eliminated in consolidation |
| 5  |                                      | Factual    | CY                 | To adjust FBWT for receipts after cutoff date.  | N<br>F  | 5100<br>1010    | Earned revenue - Program B<br>FBWT                                | \$10,000 |                        | \$10,000 | Earned revenue<br>FBWT eliminates in consolidation        |
| Adjustments for the effect of misstatements as of the end of the current year: |                                      |            |                    |   |   |                 |   |          |                        |          |   |
|  |                                      | Factual    | CY                 | To decrease current year operating expenses as a result   | N   | 3000            | Beginning net position  | \$300    |                        |          | Net position, beginning of period                         |

Reporting Phase  
595 C – Uncorrected Misstatements and Adjusting Entries

| Adj.<br># | Management will record?              |  |   |   |      |                                |                        |        |   |
|-----------|--------------------------------------|--|---|---|------|--------------------------------|------------------------|--------|---|
|           | Factual, judgmental or projected?    |  |   | Federal governmental (F) or nonfederal public (N) |      |                                | (Dollars in thousands) |        | Corresponding U.S. government's CFS line item |
|           | Prior year (PY) or current year (CY) |  |   | SGL account number                                |      |                                |                        |        |   |
|           | Description                          |  |   | SGL Description                                   |      |                                | Debit                  | Credit |   |
|           |                                      |  | of the reversal of the correcting entry for the prior year cut-off error of operating expenses (adjustment number 2), which does not affect misstatements on the balance sheet as of the end of the current year. | N   | 6100 | Operating expenses – Program A |                        | \$300  |   |

Note: The line items presented mirror those in the entity's financial statements.

## Example 2 – Summary of Uncorrected Misstatements (after Discussions with Management)

(After discussions with management (FAM 595 C.06 through .09), a summary of uncorrected misstatements is created from Example 1 that management has declined to correct. See FAM 595 C.10 and .12)

| (Dollars in thousands)<br>(1)           | Adjustment<br>number<br>(2) | Factual,<br>judgmental, or<br>projected<br>misstatement<br>(3) | Line item<br>balance<br>(4) | Total misstatements<br>(5) |       |          | Effect of prior<br>year<br>misstatements<br>(6) | Adjusted line item<br>balance – effect of<br>misstatements<br>originating in the<br>current year<br>(7) = (4) + (5) + (6) | Misstatement<br>as percentage<br>of reported<br>line item -<br>effect of<br>misstatements<br>originating in<br>the current<br>year<br>(8) | Adjustments<br>for the effect<br>of<br>misstatements<br>on the<br>balance sheet<br>as of the end<br>of the current<br>year<br>(9) | Adjusted line<br>item balance –<br>effect of<br>misstatements<br>on the balance<br>sheet as of the<br>end of the<br>current year<br>(10) = (7) + (9) | Misstatement<br>as percentage<br>of reported<br>line item -<br>effect of<br>misstatements<br>as of the end<br>of the current<br>year<br>(11) |
|---|-----------------------------|--|-----------------------------|----------------------------|-------|----------|---|---|---|---|--|--|
|   |                             |  |                             | Debit/(Credit)             | Debit | (Credit) | Net<br>Debit/(Credit)                           |   |   |   |  |  |
| <b>Balance Sheet<sup>2</sup></b>        |                             |  |                             |                            |       |          |   |   |   |   |  |  |
| <b>Assets</b>                           |                             |  |                             |                            |       |          |   |   |   |   |  |  |
| Fund balance with Treasury              |                             |  | 50,000                      |                            |       |          |   | 50,000  | 0.00%   |   | 50,000   | 0.00%  |
| Accounts receivable, net                | 3                           | F  | 125                         |                            |       | (25)     | (105)   | 20  | -84.00%   |   | 20   | -84.00%  |
|   | 4                           | P  |                             |                            |       | (80)     |   |   |   |   |  |  |
| Loans receivable, net                   |                             |  | 1,000                       |                            |       |          |   | 1,000   | 0.00%   |   | 1,000  | 0.00%  |
| PPE, net                                |                             |  | 40,000                      |                            |       |          |   | 40,000  | 0.00%   |   | 40,000   | 0.00%  |
| Inventory                               |                             |  | 8,000                       |                            |       |          |   | 8,000   | 0.00%   |   | 8,000  | 0.00%  |
| Total assets                            |                             |  | 99,125                      |                            |       | (105)    | (105)   | 99,020  |   |   | 99,020   |  |
| <b>Liabilities</b>                      |                             |  |                             |                            |       |          |   |   |   |   |  |  |
| Accounts payable -<br>nonfederal public | 1                           | J  | (2,000)                     |                            |       | (230)    | (230)   | (2,230)   | 11.50%  |   | (2,230)  | 11.50%   |
| Other liabilities                       | 2                           | F  | (5,250)                     | 200                        |       |          | 200   | (5,050)   | -3.81%  |   | (5,050)  | -3.81%   |
| Total liabilities                       |                             |  | (7,250)                     | 200                        |       | (230)    | (30)  | (7,280)   |   |   | (7,280)  |  |
| <b>Net Position</b>                     |                             |  |                             |                            |       |          |   |   |   |   |  |  |
| Beginning Net Position                  |                             |  | (104,675)                   |                            |       |          |   | (300)   | 0.29%   | 300   | (104,675)  | 0.00%  |

<sup>2</sup> As needed, create additional schedules for other financial statements that have adjustments.

Reporting Phase  
595 C – Uncorrected Misstatements and Adjusting Entries

| (Dollars in thousands)<br>(1)         | Adjustment<br>number<br>(2) | Factual,<br>judgmental, or<br>projected<br>misstatement<br>(3) | Line item<br>balance<br>(4)<br><br>Debit/(Credit) | Total misstatements<br>(5) |          |                       | Effect of prior<br>year<br>misstatements<br>(6)<br><br>Debit/(Credit) | Adjusted line item<br>balance – effect of<br>misstatements<br>originating in the<br>current year<br>(7) = (4) + (5) + (6)<br><br>Debit/(Credit) | Misstatement<br>as percentage<br>of reported<br>line item -<br>effect of<br>misstatements<br>originating in<br>the current<br>year<br>(8) | Adjustments<br>for the effect<br>of<br>misstatements<br>on the<br>balance sheet<br>as of the end<br>of the current<br>year<br>(9) | Adjusted line<br>item balance –<br>effect of<br>misstatements<br>on the balance<br>sheet as of the<br>end of the<br>current year<br>(10) = (7) + (9)<br><br>Debit/(Credit) | Misstatement<br>as percentage<br>of reported<br>line item -<br>effect of<br>misstatements<br>as of the end<br>of the current<br>year<br>(11) |
|---------------------------------------|-----------------------------|--|---|----------------------------|----------|-----------------------|---|---|---|---|--|--|
|                                       |                             |  |   | Debit                      | (Credit) | Net<br>Debit/(Credit) |   |   |   |   |  |  |
| Net current year (surplus)<br>deficit | 1                           | J  | 12,800  | 230                        |          | 135                   |   | 13,235  | 3.40%   | (300)   | 12,935   | 1.05%  |
|                                       | 2                           | F  |   |                            | (200)    |                       | 300   |   |   |   |  |  |
|                                       | 3                           | F  |   | 25                         |          |                       |   |   |   |   |  |  |
|                                       | 4                           | P  |   | 80                         |          |                       |   |   |   |   |  |  |
| Total net position                    |                             |  | (91,875)  | 335                        | (200)    | 135                   |   | (91,740)  |   |   | (91,740)   |  |
| Total liabilities and net<br>position |                             |  | (99,125)  | 535                        | (430)    | 105                   |   | (99,020)  |   |   | (99,020)   |  |
| Total uncorrected<br>misstatements    |                             |  |   | 535                        | (535)    |                       | 300   |   |   | 300   |  |  |
| <u>Statement of Net Cost</u>          |                             |  |   |                            |          |                       |   |   |   |   |  |  |
| Net cost of operations:               |                             |  |   |                            |          |                       |   |   |   |   |  |  |
| Program A:                            |                             |  |   |                            |          |                       |   |   |   |   |  |  |
| Gross cost - nonfederal<br>public     | 1                           | J  | 19,800  | 230                        |          | 30                    |   | 20,130  | 1.16%   | (300)   | 19,830   | -3.89%   |
|                                       | 2                           | F  |   |                            | (200)    |                       | 300   |   |   |   |  |  |
| Less: earned revenue                  |                             |  | (23,000)  |                            |          |                       |   | (23,000)  | 0.00%   |   | (23,000)   | 0.00%  |
| Net cost Program A                    |                             |  | (3,200)   | 230                        | (200)    | 30                    | 300   | (2,870)   | -10.31%   | (300)   | (3,170)  | -0.94%   |
| Program B:                            |                             |  |   |                            |          |                       |   |   |   |   |  |  |
| Gross cost - nonfederal<br>public     |                             |  | 31,000  |                            |          |                       |   | 31,000  | 0.00%   |   | 31,000   | 0.00%  |
| Gross cost -<br>intragovernmental     | 3                           | F  | 500   | 25                         |          | 105                   |   | 605   | 21.00%  |   | 605  | 21.00%   |
|                                       | 4                           | P  |   | 80                         |          |                       |   |   |   |   |  |  |
| Less: earned revenue                  |                             |  | (15,500)  |                            |          |                       |   | (15,500)  | 0.00%   |   | (15,500)   | 0.00%  |
| Net cost Program B                    |                             |  | 16,000  | 105                        |          | 105                   |   | 16,105  | 0.66%   |   | 16,105   | 0.66%  |

## Reporting Phase

### 595 C – Uncorrected Misstatements and Adjusting Entries

| (Dollars in thousands)<br>(1) | Adjustment<br>number<br>(2) | Factual,<br>judgmental, or<br>projected<br>misstatement<br>(3) | Line item<br>balance<br>(4)<br><br>Debit/(Credit) | Total misstatements<br>(5) |          |                       | Effect of prior<br>year<br>misstatements<br>(6)<br><br>Debit/(Credit) | Adjusted line item<br>balance – effect of<br>misstatements<br>originating in the<br>current year<br>(7) = (4) + (5) + (6)<br><br>Debit/(Credit) | Misstatement<br>as percentage<br>of reported<br>line item -<br>effect of<br>misstatements<br>originating in<br>the current<br>year<br>(8) | Adjustments<br>for the effect<br>of<br>misstatements<br>on the<br>balance sheet<br>as of the end<br>of the current<br>year<br>(9) | Adjusted line<br>item balance –<br>effect of<br>misstatements<br>on the balance<br>sheet as of the<br>end of the<br>current year<br>(10) = (7) + (9)<br><br>Debit/(Credit) | Misstatement<br>as percentage<br>of reported<br>line item -<br>effect of<br>misstatements<br>as of the end<br>of the current<br>year<br>(11) |
|-------------------------------|-----------------------------|--|---|----------------------------|----------|-----------------------|---|---|---|---|--|--|
|                               |                             |  |   | Debit                      | (Credit) | Net<br>Debit/(Credit) |   |   |   |   |  |  |
| Total net cost of operations  |                             |  | 12,800  | 335                        | (200)    | 135                   | 300   | 13,235  | 3.40%   | (300)   | 12,935   | 1.05%  |

#### Legend:

Total misstatements – All misstatements arising in the current year are included in this column. This does not include misstatements arising in prior years (e.g., included in the prior year Summary of Uncorrected Misstatements or misstatements identified in the current year that should be included in the prior year Summary of Uncorrected Misstatements.)

Misstatements in this column correspond to adjusting entries included below.

Effect of prior year misstatements – Current year misstatements as a result of misstatements arising in prior years (e.g., reversal of items included in the prior year Summary of Uncorrected Misstatements are included in this column.) Misstatements in this column correspond to adjusting entries included below.

Adjusted line item balance – effect of misstatements originating in the current year – This column shows the adjusted line item balance after accounting for the effect of total misstatements originating in the current year.

Misstatement as percentage of reported line item (effect of misstatements originating in the current year) – The effect of misstatements originating in the current year as a percentage of the reported line item balance is displayed in this column to help assess the materiality of the misstatement on each line item.

Adjustments for the effect of misstatements on the balance sheet as of the end of the current year – This column includes any adjustments to misstatements as a result of switching approaches from quantifying misstatements originating in the current year to quantifying all misstatements as of the end of the current year, regardless of the period in which the misstatement arose. This column can include reversals of misstatements that were included when only considering the effect of misstatements originating in the current year. Misstatements in this column correspond to adjusting entries included below.

Adjusted line item balance - effect of misstatements on the balance sheet as of the end of the current year – This column shows the adjusted line item balance after accounting for any adjustments needed to consider the effect of all misstatements as of the end of the current year.

Misstatement as percentage of reported line item (effect of misstatements as of the end of the current year) - Misstatements as of the end of the current year are displayed in this column as a percentage of the reported line item balance to help assess the materiality of the misstatement on each line item.

We discussed the Summary of Uncorrected Misstatements with Joe Jones, CFO, and Sandra Hawkins, COO, on 11/1/XX. We encouraged them to make adjustments for all of the factual misstatements and investigate the judgmental and projected misstatements. They corrected misstatement #5 in the financial statements because they believed it was material. When considering the effect of misstatements originating in the current year and the effect of misstatements as of the end of the current year, management concluded that the other misstatements were not material, but that after the audit they would consider whether internal control needed strengthening in these areas. On 11/4/xx, we discussed misstatements with the entity's Executive Committee, including the entity's head Jane Green. The Executive Committee agreed with the actions taken by management.

Conclusion: The effect of uncorrected misstatements originating in the current year excluding the effects of misstatements arising in prior years (\$135,000) and the effect of all uncorrected misstatements originating in the current year (\$435,000) on total net cost are each less than our materiality for the financial statements as a whole of \$1,524,000 (3% of gross cost with the public of \$50.8 million— our materiality benchmark). In addition, we found that the effect of the uncorrected misstatements originating in the current year excluding the effects of misstatements arising in prior years (\$30,000) and the effect of all uncorrected misstatements originating in the current year (\$330,000) on total gross cost with the public are each less than our materiality for the financial statements as a whole. Further, the effect of all uncorrected prior period misstatements on the balance sheet as of the end of the current year (\$135,000) on both total net cost and total gross cost with the public is also less than materiality for the financial statements as a whole. We also considered the effect of the uncorrected misstatements on other line items on the financial statements. We also considered whether these misstatements were qualitatively material. Based on this analysis, we concur with management that the uncorrected misstatements are not material to the financial statements.

In addition, we have obtained sufficient appropriate audit evidence to conclude that there is an acceptably low risk that projected misstatement plus an allowance for further misstatement would be material.

Note: For illustration purposes, only the balance sheet and net cost misstatements are presented. When presented to management, the effect of misstatements on all entity financial statements is presented.

## Example 2 – Adjusting Entries to Correct Misstatements (after Discussion with Management)

| Adj.<br>#  | Management will record? |                                   |                                      |   |   |                    |                                   |       |        |   |
|--|-------------------------|-----------------------------------|--------------------------------------|---|---|--------------------|-----------------------------------|-------|--------|---|
|  |                         | Factual, judgmental or projected? |                                      |   | Federal governmental (F) or nonfederal public (N) |                    | (Dollars in thousands)            |       |        | Corresponding U.S. government's CFS line item             |
|  |                         |                                   | Prior year (PY) or current year (CY) |   |   |                    |                                   |       |        |   |
|  |                         |                                   |                                      | Description   |   |                    |                                   |       |        |   |
|  |                         |                                   |                                      |   |   | SGL account number | SGL Description                   | Debit | Credit |   |
| 1  | No                      | Judgmental                        | CY                                   | To accrue accounts payable for Program A.   | N   | 6100               | Operating expenses – Program A    | \$230 |        | Gross costs   |
|  |                         |                                   |                                      |   | N   | 2110               | Accounts payable                  |       | \$230  | Accounts payable  |
| 2  | No                      | Factual                           | CY                                   | To decrease operating expenses arising in the current year from the current year cut-off error.   | N   | 2990               | Other liabilities                 | \$200 |        | Other liabilities   |
|  |                         |                                   |                                      |   | N   | 6100               | Operating expenses – Program A    |       | \$200  | Gross costs   |
|  | No                      | Factual                           | PY                                   | To increase current year operating expenses arising from the prior year cut-off error (from prior year Summary of Uncorrected Misstatements).   | N   | 6100               | Operating expenses – Program A    | \$300 |        | Gross costs   |
|  |                         |                                   |                                      |   | N   | 3000               | Beginning net position            |       | \$300  | Net position, beginning of period                         |
| 3  | No                      | Factual                           | CY                                   | To increase current year loan bad debt expense in Program B. [Actual error amount of an intragovernmental sample item.]   | F   | 6720               | Bad debt expense – Program B      | \$25  |        | Intragovernmental amounts are eliminated in consolidation |
|  |                         |                                   |                                      |   | F   | 1319               | Allowance for accounts receivable |       | \$25   |   |
| 4  | No                      | Projected                         | CY                                   | To increase current year loan bad debt expense in Program B. [Additional projected misstatement as a result of actual error amount of sample item from Adj #3 above projected to the population. Total projected misstatement of \$105 less \$25 actual misstatement]     | F   | 6720               | Bad debt expense – Program B      | \$80  |        | Intragovernmental amounts are eliminated in consolidation |
|  |                         |                                   |                                      |   | F   | 1319               | Allowance for accounts receivable |       | \$80   |   |
| Adjustments for the effect of misstatements as of the end of the current year: |                         |                                   |                                      |   |   |                    |                                   |       |        |   |
|  | No                      | Factual                           | CY                                   | To decrease current year operating expenses as a result of the reversal of the correcting entry for the prior year cut-off error of operating expenses (adjustment number 2), which does not affect misstatements on the balance sheet as of the end of the current year. | N   | 3000               | Beginning net position            | \$300 |        | Net position, beginning of period                         |
|  |                         |                                   |                                      |   | N   | 6100               | Operating expenses – Program A    |       | \$300  | Gross costs   |



### Example 3 – Summary of Corrected Misstatements (after Discussion with Management)

(This summary schedule shows the misstatement from example 2 that management has agreed to correct. See FAM 595 C.11.)

| Adj.<br># | Management will record?              |         |                    |   |   |      |                            |          |          |  |
|-----------|--------------------------------------|---------|--------------------|---|---|------|----------------------------|----------|----------|--|
|           | Factual, judgmental or projected?    |         |                    |   | Federal governmental (F) or nonfederal public (N) |      | (Dollars in thousands)     |          |          | Corresponding U.S.<br>government's CFS line item |
|           | Prior year (PY) or current year (CY) |         | SGL account number |   |   |      |                            |          |          |  |
|           | Description                          |         | SGL Description    |   | Debit   |      | Credit                     |          |          |  |
| 5         | Yes                                  | Factual | CY                 | To reconcile FBWT for receipts after cutoff date. | N   | 5100 | Earned revenue - Program B | \$10,000 |          | FBWT eliminates in consolidation                 |
|           |                                      |         |                    |   | F   | 1010 | FBWT                       |          | \$10,000 |  |

## **Glossary**

|   |  |
|---|--|
| <b>Accounting applications</b>          | <p>The methods and records used to (1) identify, assemble, analyze, classify, and record a particular type of transaction or (2) report recorded transactions and maintain accountability for related assets and liabilities. Accounting applications often include information system processing. Information system processing is often performed by software programs hosted by information systems, which are also commonly referred to as applications. Common accounting applications are (1) billings, (2) accounts receivable, (3) cash receipts, (4) purchasing and receiving, (5) accounts payable, (6) cash disbursements, (7) payroll, (8) inventory control, and (9) property, plant, and equipment (PP&amp;E).</p> |
| <b>Accounting estimate</b>              | <p>An approximation of a monetary amount in the absence of a precise means of measurement.</p>   |
| <b>Accounting system</b>                | <p>The methods, records, and processes used to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.</p>   |
| <b>Accuracy/valuation or allocation</b> | <p>Amounts and other data relating to recorded transactions and events have been recorded appropriately. Assets, liabilities, and net position are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are properly recorded. Financial and other information is disclosed fairly and at appropriate amounts.</p>   |
| <b>Analytical procedures</b>            | <p>The evaluations of financial information made through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.</p>  |
| <b>Annual financial statement</b>       | <p>As defined by OMB, the annual financial statement comprises:</p> <ul style="list-style-type: none"><li>• unaudited Management's Discussion and Analysis (MD&amp;A),</li></ul>   |

- audited basic financial statements, including note disclosures,
- unaudited required supplementary stewardship information (RSSI), if applicable,
- unaudited required supplementary information (RSI), if applicable, and
- unaudited other accompanying information, if applicable.

This report is also referred to as the Performance and Accountability Report (PAR).

**Applicable financial reporting framework**

Provides the criteria for management to present the financial statements of an entity, including the fair presentation of those financial statements (e.g., U.S. GAAP). The Federal Accounting Standards Advisory Board (FASAB) is the body designated by the AICPA as the source of U.S. GAAP for federal reporting entities.

**Application controls**

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.

**Appropriateness**

Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

**Appropriation**

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.

**Assertions**

Management representations that are embodied in financial statement components. The FAM classifies assertions in the following five broad categories (as described in FAM 235.02):

- Existence or occurrence
- Completeness
- Rights and obligations
- Accuracy/valuation or allocation
- Presentation and disclosure

**Assistant director**

The person responsible for the operational conduct of the audit and generally for preparation of the audit report. In public accounting firms, the audit manager may have these responsibilities.

**Assurance, level of**

The complement of audit risk, which is an auditor judgment. This is not the same as confidence level, which relates to an individual sample.

**Attribute sampling**

Statistical sampling that reaches a conclusion about a population in terms of a rate of occurrence.

**Audit director (first partner)**

The person responsible for the quality of the financial statement audit and the audit report, reporting to the assistant IG for the audit or, at GAO, to the managing director.

**Audit evidence**

All the information used by the auditor in arriving at the conclusions on which the auditor's reports are based, including the information contained in the accounting records underlying the financial statements and other information.

**Audit risk**

The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is composed of inherent risk, control risk, risk of material misstatement, detection risk, and fraud risk.

**Borrowing authority**

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.

**Budget authority**

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. The basic forms of budget authority include (1) appropriations, (2) borrowing authority, (3) contract authority, and (4) authority to obligate and expend offsetting receipts and collections.

**Budget controls**

Management's policies and procedures for managing and controlling the use of appropriated funds and other forms of budget authority.

**Canceled (closed) account**

An appropriation account whose balance has been canceled. Once balances are canceled, the amounts are not available for obligation or expenditure for any purpose.

**Cause and effect basis**

In cost accounting, a way to group costs into cost pools in which an intermediate activity may be a link between the cause and the effect.

**Classical probability  
proportional to size  
sampling**

A sample selection procedure that selects items for the sample in proportion to their relative size, usually their monetary amounts. Monetary unit sampling uses this method to select the sample.

**Classical variables  
(estimation)  
sampling**

A sampling approach that measures sampling risk using the variation of the underlying characteristic of interest. This approach includes methods such as mean-per-unit, ratio estimation, difference estimation, and a classical form of probability proportional to size estimation.

**Clearly trivial**

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.

**Client**

In the federal environment, the "client" may include the

- management of the federal entity to be audited, including senior executive and financial managers;
- inspector general (IG) if the IG has contracted for the audit;
- members of a board or commission responsible for the federal entity; and/or

- audit committee.

**Combined precision**

The achieved precision for all statistical sampling applications.

**Commitment letter**

A letter used by some auditors, either after a survey of work or the planning phase has been completed to confirm a commitment for a congressional request, mandate, or auditor's statutory discretionary authority for any type of work.

**Common data source**

All of the financial and programmatic information available for the budgetary, cost, and financial accounting processes. It includes all financial and much non-financial data, such as environmental data, that are necessary for budgeting and financial reporting as well as evaluation and decision information developed as a result of prior reporting and feedback.

**Compensating control**

A control that limits the severity of a control deficiency and prevents it from rising to the level of significant deficiency or, in some cases, a material weakness.

**Completeness**

All transactions and events that should have been recorded are recorded in the proper period. All assets, liabilities, and net position that should have been recorded have been recorded in the proper period and properly included in the financial statements.

**Compliance control**

A process, by management and others, designed to provide reasonable assurance regarding the achievement of objectives for compliance with applicable laws, regulations, contracts and grant agreements.

**Compliance system**

The entity's policies and procedures to monitor compliance with laws, regulations, contracts, and grant agreements applicable to the entity.

**Compliance tests**

Tests to obtain evidence on the entity's compliance controls for each significant provision of laws, regulations, contracts, and grant agreements identified for testing, including budget controls for each relevant budget restriction.

|                            |   |
|----------------------------|---|
| <b>Component auditor</b>   | An auditor who performs work on the financial information of a component that will be used as audit evidence for the group audit.   |
| <b>Confidence interval</b> | A statistical sample-based estimate expressed as an interval or range of values. The sample is designed such that there is a specified confidence level for which the population value being estimated is expected to be located within the interval. More specifically, it is the projected misstatement or point estimate plus or minus precision at the desired confidence level and is also known as a precision or precision interval. |
| <b>Confidence level</b>    | The probability associated with the precision, that is, the probability that the true misstatement is within the confidence interval. This is not the same as assurance.  |
| <b>Contingency</b>         | An existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur.  |
| <b>Contract authority</b>  | 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.   |
| <b>Control activities</b>  | <p>One of the five components of internal control, in addition to control environment, risk assessment, information and communications, and monitoring.</p> <p>Control activities are the policies, procedures, techniques, and mechanisms that help ensure that management directives are carried out and respond to risks in the internal control system, which includes the entity's information system.</p>                             |
| <b>Control deficiency</b>  | A condition 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.

**Control environment**

One of the five components of internal control, in addition to risk assessment, control activities, information and communications, and monitoring.

Control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

**Control objective**

The aim or purpose of specified controls. Control objectives address the risks that the controls are intended to mitigate. In the context of ICFR, a control objective generally relates to a relevant assertion for a significant class of transactions, account balance, or disclosure and addresses the risk that the controls in a specific area will not provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented, or detected and corrected, on a timely basis.

**Control risk**

The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure 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. That 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.

**Control tests**

Audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

**Cost**

The monetary value of resources used or sacrificed or liabilities incurred to achieve an objective, such as to acquire or produce a good or to perform an activity or service.



|                             |   |
|-----------------------------|---|
| <b>Cycle</b>                | A grouping of related accounting applications.  |
| <b>Cycle matrix</b>         | A workpaper that links each of the entity's accounts (in the chart of accounts) to a cycle, an accounting application, and a financial statement line item.   |
| <b>Degree of compliance</b> | <p>The following terms are used throughout the FAM to describe the degree of compliance with the standard or policy:</p> <ul style="list-style-type: none"><li>•<b>Must:</b> Compliance is mandatory when the circumstances exist to which the requirement is relevant. Most "musts" indicate unconditional requirements that come directly from professional auditing standards while other instances of "must" are unique needs for the government environment and, therefore, determined by GAO/CIGIE to be required.</li><li>•<b>Should:</b> Compliance is mandatory when the circumstances exist to which the requirement is relevant, except in rare circumstances when the specific procedure to be performed would be ineffective in achieving the intent of the requirement. The auditor must document (1) the justification for any departure and (2) how the alternative audit procedures performed were sufficient to achieve the intent of the requirement or policy. The documentation should be approved by the reviewer.</li><li>•<b>Generally should:</b> Compliance is strongly encouraged when the circumstances exist to which this policy is relevant. The auditor should discuss any departure with the assistant director (or equivalent, such as the audit manager in a public accounting firm) and document such discussions.</li><li>•<b>May, might, could:</b> These terms are used in the FAM to provide further explanation of and guidance for implementing audit requirements. Compliance is optional. The auditor need not document compliance.</li></ul> |
| <b>Detection risk</b>       | The risk that the procedures performed by the auditor 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. It is a   |

function of the effectiveness of an audit procedure and of its application by the auditor.

**Disclosure entities**

Organizations similar to consolidation entities in that they are either (a) in the budget, (b) majority owned by the government, (c) controlled by the government, or (d) would be misleading to exclude. Disclosure entities have a greater degree of autonomy with the government than consolidation entities.

**Direct assistance**

The use of internal auditors to perform audit procedures under the direction, supervision, and review of the auditor.

**Emphasis-of-matter paragraph**

A paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

**Engagement letter**

A written agreement that documents the objectives and scope, roles and responsibilities of both federal entity management and the auditor, and other matters of the engagement.

**Entity-level controls**

Controls that have a pervasive effect on an entity's internal control system. Entity-level controls may include controls related to the entity's risk assessment process, control environment, service organizations, management override, and monitoring.

**Entity management**

The persons with executive responsibility for the conduct of the entity's operations.

**Entity profile**

A workpaper used by the auditor to document the information useful for understanding the entity and its operations. In this profile the auditor generally should briefly document such elements as the entity's origin, history, mission, size, locations, organization, and key members of management; the legal and regulatory framework; the applicable financial reporting framework and external and internal factors affecting operations; use of information systems; and accounting policies.

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| <b>Errors</b>  | Mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared.   |
| <b>Existence or occurrence</b>                           | Recorded transactions and events occurred during the given period, are properly classified, and pertain to the entity. An entity's assets, liabilities, and net position exist at a given date.   |
| <b>Expectation</b>                                       | The auditor's estimate of a recorded amount (based on an analysis and understanding of relationships between the recorded amounts and other data) in an analytical procedure.   |
| <b>Expected misstatement</b>                             | The dollar amount of misstatements the auditor expects in a population.   |
| <b>Expired accounts (appropriations)</b>                 | Accounts in which the balances are no longer available for incurring new obligations because the time available for incurring such obligations has expired.   |
| <b>External confirmation</b>                             | Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), either in paper form or by electronic or other medium (for example, through the auditor's direct access to information held by a third party).   |
| <b>Factual misstatement</b>                              | A misstatement in which there is no doubt about the amount of the misstatement.   |
| <b>Federal financial management systems requirements</b> | Consists of three parts: (a) reliable financial reporting, (b) effective and efficient operations, and (c) compliance with applicable laws and regulations. OMB and Treasury will develop, issue, and maintain the Federal Financial Management System Requirements to support these areas and publish them in the TFM.                               |
| <b>Federal reporting entities</b>                        | Reporting entities are organizations that issue a general purpose federal financial report because either there is a statutory or administrative requirement to prepare one or they choose to prepare one. The term "reporting entity" may refer to either the government-wide reporting entity or a component reporting entity. Statement of Federal |

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|   | Financial Accounting Concepts (SFFAC) 2 provides criteria for an entity to be a reporting entity.   |
| <b>Financial management systems</b>   | 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 the operation and maintenance of system functions.  |
| <b>Financial reporting control</b>  | A process, created by management and other personnel, designed to provide reasonable assurance regarding the achievement of financial reporting objectives.   |
| <b>Financial statements (also called the basic or principal statements)</b> | <p>A component of a federal entity's annual financial statement (also referred to as the Accountability Report), which consist of:</p> <ul style="list-style-type: none"><li>• Balance Sheet</li><li>• Statement of Net Cost</li><li>• Statement of Changes in Net Position</li><li>• Statement of Budgetary Resources</li><li>• Statement of Custodial Activity (if applicable)</li><li>• Statement of Social Insurance (if applicable)</li><li>• Related note disclosures</li></ul> |
| <b>Fraud</b>  | An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit.   |
| <b>Fraud risk</b>   | The risk of fraudulent financial reporting and the risk of misappropriation of assets that cause a material misstatement of the financial statements.   |
| <b>Fraudulent financial reporting</b>                                       | Intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting could involve intentional alteration of accounting records, misrepresentation of transactions, intentional misapplication of accounting principles, or other means.   |

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| <b>Full cost</b>                         | The total amount of resources used to produce the output. More specifically, the full cost of an output produced by a responsibility segment is the sum of (1) the costs of resources consumed by the responsibility segment that directly or indirectly contribute to the output and (2) the costs of identifiable supporting services provided by other responsibility segments within the reporting entity and by other reporting entities. |
| <b>Fund Balance with Treasury (FBWT)</b> | An asset account representing the unexpended spending authority in entity appropriations. Also serves as a mechanism to prevent entity disbursements from exceeding appropriated amounts.  |
| <b>General controls</b>                  | General controls are the policies and procedures that apply to all or a large segment of an entity's information system. General controls help ensure the proper operation of information systems by creating the environment for proper operation of application controls.  |
| <b>Haphazard sample</b>                  | A sample consisting of sampling units selected without any conscious bias, that is, without any special reason for including or omitting items from the sample. It does not consist of sampling units selected in an arbitrary manner, rather it is selected in a way the auditor expects to be representative of the population.  |
| <b>Heritage assets</b>                   | Property, plant, and equipment that are unique for one or more of the following reasons: (1) historical or natural significance, (2) cultural, educational, artistic (or aesthetic) importance, or (3) significant architectural characteristics.  |
| <b>Information and communication</b>     | <p>One of the five components of internal control, in addition to control environment, entity risk assessment, control activities, and monitoring.</p> <p>Information and communication systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.</p>  |

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| <b>Information system</b>                  | A discrete set of information resources organized for the collection, processing, maintenance, use, sharing, dissemination, or disposition of information.  |
| <b>Information system controls</b>         | Internal controls that are dependent on information systems processing and include general controls (entitywide, system, and application levels), application controls (input, processing, output, master file, interface, and data management system controls), and user controls (controls performed by people interacting with information systems). |
| <b>Information system controls auditor</b> | A person with technical expertise in information technology systems, general controls, applications, and information security. This person is involved with the planning, directing, or performing of audit procedures related to assessing information system controls.  |
| <b>Information system processing</b>       | Processing performed by information systems through the use of information technology.  |
| <b>Information technology specialist</b>   | A person possessing 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 information system controls auditing.  |
| <b>Inherent risk</b>                       | The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.  |
| <b>Integrated audit</b>                    | An audit of internal control over financial reporting that is integrated with an audit of financial statements  |
| <b>Intent letter</b>                       | A letter used by some auditors to acknowledge a congressional request for any type of work.   |
| <b>Inter-entity</b>                        | Activity and balances occurring between federal entities that are trading partners. Inter-entity and intra-entity amounts comprise intragovernmental activity and balances.   |

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| <b>Internal audit function</b>                                | A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management, and internal control processes.   |
| <b>Internal control</b>                                       | Internal control is a process effected by oversight body, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. |
| <b>Internal control phase</b>                                 | This audit phase entails understanding, testing, and assessing internal control over financial reporting to reach conclusions about the reliability of financial reporting and compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.   |
| <b>Internal control over financial reporting</b>              | A subset of the entity's internal control and includes reliability of financial statements and compliance with laws, regulations, contracts, and grant agreements.  |
| <b>Intra-entity</b>   | Activity and balances occurring within a federal entity. Intra-entity and inter-entity amounts comprise Intragovernmental activity and balances.  |
| <b>Intragovernmental amounts</b>                              | Activity and balances occurring within a federal entity (i.e. intra-entity) or between federal entities (i.e. inter-entity).  |
| <b>Intragovernmental Payment and Collection (IPAC) system</b> | The primary method used by most federal entities to electronically bill and/or pay for services and supplies within the U.S. government. IPAC is used to communicate between the Treasury and the trading partner entities that the online billing and/or payment for services and supplies has occurred.   |
| <b>Iron curtain approach</b>                                  | An approach used to evaluate misstatements. This approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement's year of origination.   |

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| <b>Joint Financial Management Improvement Program (JFMIP)</b> | The original source of governmentwide requirements for financial management systems software functionality that describes the basic elements of an integrated financial management system (including the core financial system). These requirements are now issued by OMB. This former joint undertaking consisted of the U.S. Department of the Treasury, the U.S. Government Accountability Office (GAO), the Office of Management and Budget (OMB), and the Office of Personnel Management (OPM). |
| <b>Judgment fund</b>  | A permanent and indefinite appropriation administered by the Department of the Treasury that is available to pay judgments, settlement agreements, and certain types of administrative awards against the United States when such payment is not otherwise provided for in entity appropriations.  |
| <b>Judgmental misstatement</b>                                | Misstatements arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection of accounting policies that the auditor considers inappropriate.   |
| <b>Limit</b>  | Used in performing substantive analytical procedures, the limit is the amount of difference between the expected and the recorded amount that the auditor will accept without investigation.   |
| <b>Limitation</b>   | A restriction on the amount, purpose, or period of availability of budget authority. While limitations are most often established through appropriations acts, they may also be established through authorization legislation. Limitations may be placed on the availability of funds for program levels, administrative expenses, direct loan obligations, loan guarantee commitments, or other purposes.   |
| <b>Line item risk analysis (LIRA)</b>                         | A workpaper that contains the audit plan for each significant line item and identifies significant line items, assertions, and cycles/accounting applications and the related risks of material misstatement at the relevant assertion level. The auditor should also summarize and document the specific risks of material misstatement, other than   |



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|  | pervasive risks, including the inherent, fraud, and control risk factors, for use in determining the nature, extent, and timing of audit procedures.   |
| <b>Logical unit</b>  | The balance or transaction that includes the selected dollar in a monetary unit sample.  |
| <b>Management</b>  | 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.   |
| <b>Management's specialist</b>                             | An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.  |
| <b>Materiality</b>   | The magnitude of an item's omission or misstatement in a financial statement that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item (FASB Statement of Financial Concepts No. 2). See materiality for the financial statements as a whole, performance materiality, design materiality, and tolerable misstatement.   |
| <b>Materiality benchmark</b>                               | The element of the financial statements that the auditor judges is most significant to the primary users of the statements. The basis for which materiality is calculated.   |
| <b>Materiality for the financial statements as a whole</b> | The auditor's preliminary estimate of materiality in relation to the financial statements taken 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 laws, regulations, contracts, and grant agreements for compliance testing. |
| <b>Material weakness</b>                                   | 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.

**Misappropriation of assets**

Theft of an entity's assets causing misstatements in the financial statements.

**Misstatement**

A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with the applicable financial reporting framework. Misstatement can arise from fraud or error. (Also see factual misstatement, judgmental misstatement, and projected misstatement)

**Misstatement of fact**

Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

**Modified opinion**

A qualified opinion, an adverse opinion, or a disclaimer of opinion.

**Monetary unit sampling**

A variables sampling evaluation method that utilizes a probability-proportional-to-size (PPS) sample selection technique.

**Monitoring**

One of the five components of internal control, in addition to control environment, risk assessment, control activities, and information and communications.

Monitoring of controls is a process to assess the effectiveness of internal control performance over time. This consists of activities management establishes and operates to assess the quality of performance over time and promptly resolve the findings of audits and other reviews.

**Multipurpose testing**

Performing several tests, such as control tests, compliance tests, and substantive tests, on a common selection, usually a sample.

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| <b>Noncompliance</b>               | Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by those charged with governance, management, or employees. Noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.  |
| <b>Nonrecognized events</b>        | Subsequent events that provide evidence with respect to conditions that did not exist at the date of the financial statements but arose subsequent to that date.   |
| <b>Nonrepresentative selection</b> | A selection of items to reach a conclusion only on the items selected. The auditor using a nonrepresentative selection (formerly referred to as a nonsampling selection) may not project the results to the portion of the population that was not tested. Accordingly, the auditor applies appropriate analytical and/or other substantive procedures to the remaining items, unless those items are immaterial in total or the auditor has already obtained enough assurance that there is a low risk of material misstatement in the total population. The auditor also uses nonrepresentative selections to test controls through inquiry, observation, and walkthrough procedures and to obtain planning information. |
| <b>Nonstatistical sampling</b>     | A sampling technique for which the auditor considers sampling risk in evaluating an audit sample without using statistical theory to measure the risk.   |
| <b>Notification letter</b>         | A letter used by some auditors to notify federal agencies of new engagements for any type of work.   |
| <b>Obligation</b>                  | A definite commitment that creates a legal liability of the government for the payment of goods and services ordered or received, or a legal duty on the part of the U.S. that could mature into a legal liability by virtue of actions on the part of the other party beyond the control of the U.S.  |

**Office of the General Counsel (OGC)**

The office advises the auditor in (1) identifying significant provisions of applicable laws and regulations to test; (2) identifying budget restrictions; and (3) identifying and resolving legal issues encountered during the financial statement audit, such as evaluating potential instances of noncompliance.

**Offsetting receipts and collections authority**

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.

**Operations controls**

A process by management and others, designed to provide reasonable assurance regarding the achievement of objectives for the planning, productivity, quality, economy, efficiency or effectiveness of operations.

**Other auditors**

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.

**Other-matter paragraph**

A paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's professional judgment, is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report.

**Overall analytical procedures**

Analytical procedures performed as an overall financial statement review during the reporting phase.

**Overall audit strategy**

In developing the strategy, the auditor should (1) identify the characteristics of the engagement that define its scope; (2) ascertain the reporting

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|  | 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; and (4) ascertain the nature, timing, and extent of resources necessary to perform the engagement. |
| <b>Performance and Accountability Report (PAR)</b> | See annual financial statement.   |
| <b>Performance materiality</b>                     | The amount or amounts set by the auditor as a portion of materiality that the auditor allocates to particular line items, accounts, classes of transactions (such as disbursements), or disclosures.  |
| <b>Planning phase</b>                              | The objectives of this audit phase are to gain an understanding of the entity to be audited; to understand its environment, including internal control; to identify significant areas for audit; and to design effective and efficient audit procedures.  |
| <b>Point estimate</b>                              | Most likely amount of the population characteristic based on the extrapolation of the sample results.   |
| <b>Population</b>                                  | The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.  |
| <b>Precision (allowance for sampling risk)</b>     | A measure of the difference between a sample estimate (projection) and the tolerable rate of deviation or tolerable misstatement at a specified sampling risk.  |
| <b>Preliminary analytical procedures</b>           | Analytical procedures performed during the audit planning phase.  |
| <b>Presentation and disclosure</b>                 | The financial and other information in the financial statements is appropriately presented and described, and disclosures are clearly expressed. All disclosures that should have been included in the financial statements have been included. Disclosed events, transactions, and other matters have occurred and pertain to the entity.                |
| <b>Principal statements</b>                        | See financial statements.   |

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| <b>Probable</b>                         | In evaluating a contingency for pending or threatened litigation and unasserted claims, a future confirming event(s) occurring is likely to occur. For other contingencies, the future event or events are more likely than not to occur.  |
| <b>Professional judgment</b>            | The application of relevant training, knowledge, and experience, within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.   |
| <b>Professional skepticism</b>          | An attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence.  |
| <b>Projected misstatement</b>           | The auditor's best estimate of the amount of the misstatements in populations, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn.   |
| <b>Providing entity</b>                 | The entity providing services, products, goods, transfer funds, investments, debt, and/or incurring the reimbursable costs. This includes bureaus, departments, and/or programs within entities. The providing agency is the seller. The providing entity transfers out funds to another entity (transfers out) when appropriations are transferred without the exchange of goods or services. |
| <b>Public-private partnerships (P3)</b> | Risk-sharing arrangements or transactions lasting more than 5 years between public and private sector entities.  |
| <b>Random sample</b>                    | A sample selected so that every combination of the same number of items has an equal probability of selection.   |
| <b>Ratio estimation</b>                 | A classical variables sampling technique that uses the ratio of audited amounts to recorded amounts in the sample to estimate the total dollar amount of the population and an allowance for sampling risk.  |

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| <b>Reasonable assurance</b>  | In the context of an audit of financial statements, a high, but not absolute, level of assurance.  |
| <b>Reasonably possible</b>   | The chance of the future event or events occurring is more than remote but less than probable.   |
| <b>Receiving entity</b>      | The entity receiving services, products, goods, transfer funds, purchasing investments, and/or borrowing from Treasury (or other entities). This includes bureaus, departments, and/or programs within entities. The receiving entity is the purchaser. The receiving entity receives transfers of funds (transfers in) when appropriations are transferred without the exchange of goods or services. |
| <b>Reciprocal accounts</b>   | Corresponding SGL accounts that should be used by a providing/seller and receiving/buyer entity to record like intragovernmental transactions. For example, the providing entity's accounts receivable would normally be reconciled to the reciprocal account, accounts payable, on the receiving entity's records.  |
| <b>Recognized events</b>     | Subsequent events that provide additional evidence with respect to conditions that existed at the date of the financial statements and affect the estimates inherent in the process of preparing basic information and RSI.  |
| <b>Recorded amount</b>       | The financial statement amount being tested by the auditor in the specific application of substantive tests.   |
| <b>Regression estimate</b>   | An estimate of a population parameter for one variable that is obtained by substituting the known total for another variable into a regression equation calculated on the basis of sample values of the two variables. Ratio estimates are special kinds of regression estimates.  |
| <b>Reimbursable activity</b> | In intragovernmental activity, similar to goods or services, except the amounts billed to the receiving entity by the providing entity are based on some agreed-upon price, which may or may not represent market value.   |
| <b>Related parties</b>       | Under FASAB standards, organizations are considered to be related parties in the general   |

purpose federal financial report 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. Relationships and transactions between the entity and other federal entities (intragovernmental) are not considered related party relationships and transactions. Given the similarity of risks, related parties, as used in auditing standards, may also include disclosure entities, related parties, and public-private partnerships, as these terms are defined by FASAB.

**Remote**

The chance of potential liability to the entity is slight.

**Reporting phase**

This phase completes the audit based on the results of audit procedures performed in the preceding phases. This involves developing the auditor's report on the entity's (1) annual financial statements and supplementary information; (2) internal control over financial reporting; (3) financial management systems' substantial compliance with the three FFMIA requirements (for CFO Act agencies); and (4) compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.

**Required Supplementary Information**

Information that a designated accounting standards setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standards setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established.

**Responsibility segment**

A significant organizational, operational, functional, or process component that has the following characteristics: (a) its manager reports to the entity's top management, (b) it is responsible for carrying out a mission, performing a line of activities or services, or producing one or a group of products, and (c) for financial reporting and cost management purposes, its resources and results of



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|   | operations can be clearly distinguished, physically and operationally, from those of other segments of the entity.  |
| <b>Reviewer (engagement quality control reviewer or second partner)</b> | The person responsible for providing negative assurance about the quality of the audit and reports to the assistant IG for audit (or higher position) or, at GAO, is the chief accountant or designee. The reviewer may consult with other personnel as needed.   |
| <b>Rights and obligations</b>   | The entity holds or controls the rights to assets, and liabilities are the obligations of the entity at a given date.   |
| <b>Risk</b>   | See audit risk, inherent risk, control risk, risk of material misstatement, and detection risk.   |
| <b>Risk assessment</b>  | <p>One of the five components of internal control, in addition to control environment, control activities, information and communications, and monitoring.</p> <p>Risk assessment is the entity's identification, analysis, and management of risks relevant to achievement of its objectives. This assessment provides the basis for developing appropriate responses to risk.</p> |
| <b>Risk of material misstatement</b>                                    | The risk that the financial statements are materially misstated prior to the audit. It is the auditor's combined assessment of inherent risk and control risk.  |
| <b>Rollover approach</b>  | An approach used to evaluate misstatements. This approach quantifies a misstatement based on the amount of the misstatement originating in the current year Statement of Net Cost.  |
| <b>Safeguarding controls</b>  | Internal controls to protect assets from loss from unauthorized acquisition, use, or disposition of entity assets that could have a material effect on the financial statements.  |
| <b>Sample</b>   | Items selected from a population to reach a conclusion about the population as a whole. (Compare with nonrepresentative selection.)   |
| <b>Sampling</b>   | The selection and evaluation of less than 100 percent of the population of audit relevance such   |

that the auditor expects the items selected (the sample) to be representative of the population and, thus, likely to provide a reasonable basis for conclusions about the population. In this context, representative means that evaluation of the sample will result in conclusions that, subject to the limitations of sampling risk, are similar to those that would be drawn if the same procedures were applied to the entire population.

**Sampling interval**

An amount between two consecutive sample items in a systematic sample. The sampling interval is determined by dividing the number of items in the population by the desired number of selections. When used in the context of a systematic sample used to select items for monetary-unit sampling (MUS), it is the tolerable misstatement divided by the statistical risk factor.

**Sampling risk**

The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. For tests of controls, sampling risk is the risk of assessing control risk either too low or too high. For substantive testing, sampling risk is the risk of incorrect acceptance or the risk of incorrect rejection.

**Sampling unit**

Any of the individual elements, as defined by the auditor, that constitute the population.

**Sequential sampling**

A sampling plan for which the sample is selected in several steps, with each step conditional on the results of the previous steps.

**Service organization**

An organization or segment of an organization that provides services to user entities that are relevant to those user entities' internal control over financial reporting.

**Significant deficiency**

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.

**Special Investigator Unit**

The unit investigates specific allegations involving conflict-of-interest and ethics matters, contract and

procurement irregularities, official misconduct and abuse, and fraud in federal programs or activities. In the offices of the IGs, this is the investigation unit; at GAO, it is the Forensic Audits and Investigative Service team. The Special Investigator Unit provides assistance to the auditor by (1) informing the auditor of relevant pending or completed investigations of the entity and (2) investigating possible instances of fraud, waste, and abuse.

**Specific control evaluation (SCE)**

Evaluating the effectiveness of specific control activities in achieving the control objectives. This process is documented on the SCE worksheet.

**Standard General Ledger (SGL)**

A uniform chart of accounts and guidance for standardizing U.S. federal accounting. Composed of five major sections: (1) chart of accounts, (2) accounts and descriptions, (3) account transactions, (4) SGL attributes, and (5) SGL crosswalks to standard external reports. Prescribed by the Department of the Treasury in its *Treasury Financial Manual*.

**Standard General Ledger (SGL) at the transaction level**

One of the three requirements of FFMIA. Implementing the SGL at the transaction level means that transactions are recorded in full compliance with the SGL Chart of Account's descriptions and posting models/attributes that demonstrate how the SGL is to be used for recording transactions of the federal government accounting process; reports produced by the systems provide financial information, whether used internally or externally, that can be traced directly to the SGL accounts; and transactions from feeder systems, which may be summarized and interfaced into the core financial system's general ledger, are posted following SGL requirements.

**Statistical sampling**

Audit sampling that uses the laws of probability for selecting and evaluating a sample from a population for the purpose of reaching a conclusion about the population.

**Statistician (audit sampling specialist)**

The person the auditor consults for technical expertise in areas such as audit sampling, audit

sample evaluation, and selecting entity field locations to visit.

**Stewardship information**

Required supplementary stewardship information includes stewardship investments that are substantial investments made by the federal government for the benefit of the nation but are not physical assets owned by the federal government. When incurred, they are treated as expenses in determining the net cost of operations. Such investments should be measured in terms of expenses incurred for: (1) federally financed but not federally owned physical property (nonfederal physical property), (2) certain education and training programs (human capital), and (3) federally financed research and development (research and development). Nonfederal physical property investments are expenses incurred by the reporting entity for the purchase, construction, or major renovation of physical property owned by state and local governments. Human capital investments are expenses incurred to increase or maintain national economic productivity capacity and to produce outputs and outcomes that provide evidence of maintaining or increasing national productive capacity. (The definition excludes education and training expenses for federal civilian and military personnel.) Research and development investments are expenses incurred to support the search for new or refined knowledge and ideas and for the application or use of such knowledge and ideas for developing new or improved products and processes, with the expectation of maintaining or increasing national economic productive capacity or yielding other future benefits.

**Stewardship land**

Land and rights owned by the federal government but not acquired for in connect with items of general PP&E.

**Stratification**

The process of dividing a population into subpopulations, each of which is a group of sampling units that have similar characteristics. Stratification may be used to focus procedures on risk areas or to reduce variability in sampling populations.

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| <b>Subsequent events</b>                  | Events or transactions that affect the basic information or RSI that may occur or become known between the date of the financial statements and the date of the auditor's report.   |
| <b>Subsequently discovered facts</b>      | Facts that become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to revise the auditor's report.  |
| <b>Substantive analytical procedures</b>  | The comparison of a recorded amount with an expectation of that amount and subsequent investigation of any significant differences to reach a conclusion on the recorded amount.  |
| <b>Substantive audit assurance</b>        | The auditor's judgment about the probability that all substantive tests of an assertion will detect aggregate misstatements that exceed materiality. Not the same as confidence level.  |
| <b>Substantive procedures or tests</b>    | Audit procedures designed to detect material misstatements at the assertion level. Substantive procedures comprise tests of details and substantive analytical procedures.  |
| <b>Sufficiency</b>                        | Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence. |
| <b>Suitable criteria</b>                  | In agreed upon procedures engagements or other attestation engagement engagements, standards for acceptability which have the attributes of objectivity, measurability, completeness, and relevance.  |
| <b>Supplemental analytical procedures</b> | Analytical procedures to increase the auditor's understanding of account balances and transactions when detail tests are used as the sole source of substantive assurance.  |
| <b>Systematic random sampling</b>         | A method of selecting a sample in which every $n$ th item is selected using one or more random starts. When the first item is selected using judgment from the interval, the method is termed systematic sampling.                                      |

**Technical accounting and auditing expert**

The person who reports to the assistant IG for audit or higher. At GAO, this is the chief accountant or other designated expert. This expert advises on accounting and auditing professional matters and government-related issues. This person also may be the reviewer or may review reports on financial statements and reports that express opinions on financial information for compliance with professional auditing standards.

**Testing phase**

The objectives of this audit phase are to (1) obtain reasonable assurance about whether the financial statements are presented fairly, in all material respects, in accordance with U.S. GAAP; (2) determine whether the entity complied with significant provisions of applicable laws, regulations, contracts, and grant agreements; and (3) assess the effectiveness of internal control over financial reporting through testing controls often in coordination with other tests.

**Those charged with governance (Oversight body)**

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. 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, or senior executives and financial managers responsible for the entity.

**Tolerable misstatement**

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.

**Tolerable rate of deviation**

A rate of deviation set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual misstatement in the population. This is also referred to as tolerable error, tolerable rate, or tolerable deviation.

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| <b>Trading partner code</b>                                      | Assigned by the U.S. Department of the Treasury, trading partner codes are used to facilitate the preparation of the <i>Financial Report of the United States Government</i> .  |
| <b>Trading partners</b>  | Federal entities that request or provide transactions and transfers between federal entities.   |
| <b>Transfers</b>   | Shifting of all or part of the budget authority in one appropriation or fund account to another. Entities may transfer budget authority only as specifically authorized by law. For accounting purposes, the nature of the transfer determines whether the transaction is treated as an expenditure or a nonexpenditure transfer.   |
| <b><i>Treasury Financial Manual (TFM)</i></b>                    | The <i>Treasury Financial Manual</i> (TFM) is Treasury's official publication of policies, procedures, and instructions concerning financial management in the Federal Government. It is intended to promote the Government's financial integrity and operational efficiency.   |
| <b>Type 1 Report</b>   | Report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date.   |
| <b>Type 2 Report</b>   | Report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design and operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period.  |
| <b>U.S. generally accepted accounting principles (U.S. GAAP)</b> | The U.S. accounting principles that are promulgated by a standard setter approved by the AICPA. SFFAS 34 contains the hierarchy of accounting standards for financial statements of federal government entities. The standards issued by FASAB are the first level of the hierarchy. For government corporations and certain other entities, the standards issued by FASB are the first level of the hierarchy. |

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| <b>Uncorrected misstatements</b> | Misstatements that the auditor has accumulated during the audit and that have not been corrected.   |
| <b>Universe</b>                  | See population.   |
| <b>User Auditor</b>              | An auditor who audits and reports on the financial statements of a user entity.   |
| <b>User controls</b>             | Controls that are performed by people interacting with IS controls. The effectiveness of user controls typically depend on the accuracy of the information produced by the IS controls.   |
| <b>Walk-throughs</b>             | Audit procedures to help the auditor understand the design of controls and whether they have been implemented. They may also provide some evidence of control effectiveness. Walk-throughs of financial reporting controls include tracing one or more transactions from initiation, through all processing, to inclusion in the general ledger; observing the processing and applicable controls in operation; making inquiries of personnel applying the controls; and examining related documents. |



## OTHER GLOSSARIES

- NOTE 1**                      The *Federal Information System Controls Audit Manual (FISCAM)* contains a glossary of information systems terms (see GAO-09-232G, February 2009).
- NOTE 2**                      A *Glossary of Terms Used in the Federal Budget Process* contains additional terms and definitions (see GAO-05-734SP, September 2005).
- NOTE 3**                      The AICPA's *Audit Sampling Guide* contains a glossary of terms.
- NOTE 4**                      The Federal Accounting Standards Advisory Board's *Handbook of Federal Accounting Standards and Other Pronouncements, as Amended* contains a glossary of terms.

## **Abbreviations**

|                   |  |
|-------------------|--|
| <b>AFR</b>        | Agency Financial Report  |
| <b>AICPA</b>      | American Institute of Certified Public Accountants   |
| <b>AT</b>         | reference to Statements on Standards for Attestation Engagements in the AICPA Codification of Statements on Auditing Standards |
| <b>AU</b>         | reference to Statements on Auditing Standards in the sections of the AICPA Codification of Statements on Auditing Standards    |
| <b>AU-C</b>       | reference to Clarified Statements on Auditing Standards of the AICPA Codification of Statements on Auditing Standards          |
| <b>CFO</b>        | Chief Financial Officer  |
| <b>CFS</b>        | Consolidated Financial Statements  |
| <b>CIGIE</b>      | Council of the Inspectors General on Integrity and Efficiency  |
| <b>FAM</b>        | GAO/CIGIE <i>Financial Audit Manual</i>  |
| <b>FASAB</b>      | Federal Accounting Standards Advisory Board  |
| <b>FASB</b>       | Financial Accounting Standards Board   |
| <b>FBWT</b>       | Fund Balance With Treasury   |
| <b>FISCAM</b>     | <i>Federal Information System Controls Audit Manual</i>  |
| <b>FISMA</b>      | Federal Information Security Modernization Act of 2014   |
| <b>FFMIA</b>      | Federal Financial Management Improvement Act of 1996   |
| <b>FMFIA</b>      | Federal Managers' Financial Integrity Act of 1982  |
| <b>GAAP</b>       | generally accepted accounting principles (U.S.)  |
| <b>GAAS</b>       | generally accepted auditing standards (U.S.)   |
| <b>GAGAS</b>      | generally accepted government auditing standards   |
| <b>GAO</b>        | Government Accountability Office   |
| <b>GASB</b>       | Government Accounting Standards Board  |
| <b>Green Book</b> | Standards for Internal Control in the Federal Government   |
| <b>IDEA</b>       | Interactive Data Extraction and Analysis   |
| <b>IG</b>         | Inspector General  |
| <b>IS</b>         | Information systems  |
| <b>LIRA</b>       | Line Item Risk Analysis  |
| <b>MD&amp;A</b>   | Management's Discussion and Analysis   |
| <b>MUS</b>        | Monetary unit sampling [also known as dollar unit sampling (DUS)]  |

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All Audit Phases  
Abbreviations

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|---------------|---|
| <b>NIST</b>   | National Institute of Standards and Technology      |
| <b>OGC</b>    | Office of General Counsel                           |
| <b>OMB</b>    | Office of Management and Budget                     |
| <b>PAR</b>    | Performance and Accountability Report               |
| <b>PPS</b>    | probability proportional to size                    |
| <b>RSI</b>    | required supplementary information                  |
| <b>RSSI</b>   | required supplementary stewardship information      |
| <b>SCE</b>    | Specific Control Evaluation                         |
| <b>SFFAS</b>  | Statement of Federal Financial Accounting Standards |
| <b>SGL</b>    | Standard General Ledger of the U.S. government      |
| <b>SSAE</b>   | Statement on Standards for Attestation Engagements  |
| <b>TFM</b>    | Treasury Financial Manual                           |
| <b>U.S.C.</b> | United States Code                                  |