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100 - INTRODUCTION

.01 This introduction provides an overview of GAO's approach to performing financial statement audits, describes how the methodology relates to relevant auditing standards and OMB guidance, and outlines key issues to be considered in using the methodology.

OVERVIEW OF GAO'S METHODOLOGY

.02 The overall purposes of performing financial statement audits of federal entities include (1) providing reliable and useful information for decisionmakers and (2) helping to improve internal controls and underlying financial management systems. To achieve these purposes, GAO's approach to financial statement audits involves four phases:

- Plan the audit to obtain relevant information in the most efficient manner.
- Evaluate the effectiveness of the entity's internal controls.
- Test the propriety and completeness of the information included in financial statements and compliance with laws and regulations.
- Report the results of audit procedures performed.

These phases are illustrated in figure 100.1 and are summarized below.

Planning Phase

.03 While planning continues throughout the audit, the objectives of this initial phase are to identify significant areas and to design efficient audit procedures. To accomplish this, the methodology includes guidance to help in

- understanding the entity's operations, including its organization, management style, and internal and external factors influencing the operating environment;
- identifying significant accounts and accounting applications, important budget restrictions, significant provisions of laws and regulations, and relevant controls over the entity's operations;

- determining the likelihood of effective EDP-related controls;
- performing a preliminary risk assessment to identify high-risk areas; and
- planning entity field locations to visit.

Internal Control Phase

.04 This phase entails evaluating and testing internal controls to support the auditor's opinion on the fairness of management's assertion about whether controls provide reasonable assurance that

- assets are safeguarded against loss from unauthorized acquisition, use, or disposition;
- transactions are executed in accordance with budget authority and significant provisions of applicable laws and regulations; and
- transactions are properly recorded, processed, and summarized to permit the preparation of the principal statements and to maintain accountability for assets.

.05 This manual also provides guidance on evaluating internal controls related to performance measures and to operating objectives that the auditor elects to evaluate. Such controls include those related to safeguarding assets from waste or preparing statistical reports.

.06 To express an opinion on management's assertion about the effectiveness of internal controls, the auditor identifies and understands the relevant controls and tests their effectiveness, then compares his or her conclusion to management's assertion. Where controls are considered to be effective, the extent of work in the testing phase can be reduced.

.07 The methodology includes guidance on

- assessing specific levels of control risk,
- selecting controls to test,
- determining the effectiveness of EDP-related controls, and

- testing controls, including coordinating control tests with the testing phase.

Testing Phase

.08 The objectives of this phase are to (1) obtain reasonable assurance about whether the principal statements are free from material misstatements, (2) determine whether the entity complied with significant provisions of applicable laws and regulations, and (3) assess the effectiveness of internal controls through control tests that are coordinated with other tests.

.09 To achieve these objectives, the methodology includes guidance on

- designing and performing substantive, compliance and control tests;
- designing and evaluating audit samples;
- correlating risk and materiality with the nature, timing, and extent of substantive tests; and
- designing multi-purpose tests that use a common sample to test several different controls and specific accounts or transactions.

Reporting Phase

.10 This phase completes the audit by reporting useful information about the entity, based on the results of audit procedures performed in the preceding phases. This involves developing the auditor's report on the entity's principal statements, management's assertion about the effectiveness of internal controls, compliance with laws and regulations, and the overview and supplemental information's consistency with the principal statements and conformity with OMB guidance. To assist in this process, the methodology includes guidance on forming opinions on the principal statements and management's assertion about the effectiveness of internal controls, as well as how to determine which findings should be reported. Also included is a report format designed to be more understandable to the reader.

RELATIONSHIP TO APPLICABLE STANDARDS

.11 The following section describes the relationship of this audit methodology to applicable auditing standards, OMB guidance, and other GAO policy requirements. It is organized into three areas:

- relevant auditing standards and OMB guidance,
- audit requirements beyond the Yellow Book, and
- auditing standards and other policies not addressed in this Manual.

Relevant Auditing Standards and OMB Guidance

.12 This manual provides a framework for performing financial statement audits in accordance with the Government Auditing Standards (also known as generally accepted government auditing standards or GAGAS) issued by the Comptroller General of the United States ("Yellow Book"); incorporated generally accepted auditing standards (GAAS) and attestation standards established by the American Institute of Certified Public Accountants; and OMB Bulletin 93-06, "Audit Requirements for Federal Financial Statements."

.13 This manual describes an audit methodology that both integrates the requirements of the standards and provides detailed implementation guidance. The methodology is designed to achieve

- **effective audits** by considering compliance with the CFO Act, GAGAS, 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 evidence efficiently;

- **quality control** through an agreed-upon framework that can be followed by all personnel; and

- **consistency of application** through a documented methodology.

.14 The manual supplements policies and procedures described in the GAGAS and OMB Bulletin 93-06. References are made to Statements on Auditing Standards in the sections (preceded by the prefix "AU") of the Codification of Statements on Auditing Standards, issued by the American Institute of

Certified Public Accountants, that are incorporated into GAGAS and Statements on Standards for Attestation Engagements (SSAE) (preceded by the prefix "AT").

Audit Requirements Beyond the Yellow Book

.15 In addition to meeting GAGAS requirements, audits of federal entities must be designed to achieve the following objectives described in OMB Bulletin 93-06:

- expansion of the auditor's responsibility for reporting on internal controls from negative assurance to an opinion on management's assertion about the effectiveness of internal controls,
- expansion of the nature of controls that are evaluated and tested to include controls related to budget execution and compliance with laws and regulations,
- lower thresholds for reporting internal control weaknesses,
- responsibility to understand performance measures controls and assess the design of the controls and whether they have been placed in operation,
- more stringent criteria for identifying laws and regulations to be compliance tested,
- responsibility to consider the entity's process for complying with the Federal Managers' Financial Integrity Act (FMFIA), and
- responsibility to consider conformity of the overview, combining statements, and supplemental financial and management information with OMB guidance.

.16 To help achieve the goals of the CFO Act, GAO believes that the audit should be designed to achieve the following objectives, in addition to those described in OMB Bulletin 93-06:

- Determine the effects of misstatements and internal control weaknesses on (1) the achievement of operations control objectives (2), the accuracy of reports prepared by the entity, and (3) the formulation of the budget.

- Determine whether specific control techniques are properly designed and placed in operation, even if a poor control environment precludes their effectiveness.

- Obtain an overall understanding of the budget formulation process.

Auditing Standards and Other Policies Not Addressed in the Manual

.17 This manual was designed to supplement financial audit and other policies and procedures adopted by GAO, including the General Policy/Procedures Manual, Communications Manual, and related manuals. As such, it was not intended to address in detail all GAO requirements. For example, general standards concerning qualifications of personnel, independence, due professional care, and quality control are not addressed.

.18 GAO provides updates to this manual that include additional audit guidance and practice aids, such as questionnaires and audit programs. This manual supersedes the AFMD Financial Audit Group Practice Manual ("Pink Book").

KEY IMPLEMENTATION ISSUES

.19 The auditor should consider the following factors in applying the methodology to a particular entity:

- audit objectives,
- exercise of professional judgment,
- compliance with policies and procedures in the manual,
- use of technical terms,
- references to GAO positions,
- use of EDP audit specialists, and
- reference to GAO Financial Audit Manual.

Audit Objectives

.20 While certain federal entities are not subject to OMB audit guidance, financial statement audits of all federal entities should be conducted in accordance with this guidance to the extent applicable to achieve the audit's objectives.

Exercise of Professional Judgment

.21 In performing a financial statement audit, the auditor should exercise professional judgment. Consequently, the auditor should adapt the guidance in the manual to respond to unusual situations encountered in an audit.

References to GAO Positions

.22 In various sections of this manual, reference is made to obtaining approval or additional guidance from persons in certain positions in GAO. Key consultations should be documented in the audit workpapers. In applying the methodology external to GAO, the auditor should consider similar levels of approval or guidance, based on the responsibilities described below. Auditors external to GAO may contact AIMD's Financial Audit Quality Control Team (202) 512-3317 for guidance on implementing the methodology.

- **The Issue Area Director (director)** is a senior management position responsible for the technical quality of the financial statement audit, reporting to the Assistant Comptroller General responsible for GAO's Accounting and Information Management Division (AIMD) through the Director of Planning and Reporting and Director of Operations.

- **The Director of Planning and Reporting** is a senior management position responsible for the quality of the auditor's reports. This individual's staff have expertise in areas such as audit sampling, audit sample evaluation, and selecting entity field locations to visit. The Director of Planning and Reporting reports to the Assistant Comptroller General - AIMD. Situations in which the auditor should consult with the Director of Planning and Reporting or designee are summarized in Appendix A.

- **The Chief Accountant** is a senior management position reporting to both the Comptroller General and the Assistant Comptroller General of AIMD. The Chief Accountant assists and advises on (1) accounting and auditing professional matters and related national issues such as corporate governance and (2) AIMD strategy to improve federal accounting and information management. The Chief Accountant reviews reports on financial statements and reports containing opinions on financial information.

- **The Office of General Counsel/AIMD** (OGC) provides assistance to the auditor in (1) identifying provisions of laws and regulations to test, (2) identifying budget restrictions, and (3) identifying and resolving legal issues encountered in the financial statement audit, such as evaluating potential instances of noncompliance.

- **The Office of Special Investigations** (OSI) 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. OSI provides assistance to the auditor by (1) informing the auditor of any relevant or pending investigations of the entity and (2) investigating possible instances of federal fraud, waste, and abuse.

Compliance With Policies and Procedures in the Manual

.23 The following terms are used throughout the manual to describe the degree of compliance with the policy or procedure required by GAO.

- **Must:** Compliance with this policy or procedure is mandatory unless an exception is approved in writing by the Director of Planning and Reporting, such as in certain instances when a disclaimer of opinion is anticipated.

- **Should:** Compliance with this policy or procedure is expected unless there is a reasonable basis for departure from it. Any such departure and the basis for it are to be documented in a memorandum. This memorandum should be approved by the assistant director and copies sent to the issue area director and the Director of Planning and Reporting.

- **Generally Should:** Compliance with this policy or procedure is strongly encouraged. Departure from such policy or procedure should be discussed with the assistant director or the audit manager.

- **May:** Compliance with this policy or procedure is optional.

Use of Technical Terms

.24 The manual uses many existing technical auditing terms and introduces many others. To assist you, a glossary of significant terms is included in this manual.

Use of EDP Audit Specialists

.25 The manual also refers to the use of EDP audit specialists. While the auditor is ultimately responsible for assessing inherent and control risk, understanding the impact of a computerized financial management system generally requires the assistance of a person with specialized technical skills. Such EDP audit specialists should possess sufficient technical knowledge and experience to understand the EDP concepts discussed in the manual and to apply them to the audit.

Reference to GAO Financial Audit Manual

.26 When cited in workpapers, correspondence or other communication, section or paragraph numbers from this manual should be preceded by the letters "FAM". For example, this paragraph should be referred to as FAM 100.26.

SECTION 200

Planning Phase

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210 - OVERVIEW

.01 The auditor performs planning to determine an effective and efficient way to obtain the evidential matter necessary to report on the entity's annual financial statement. The nature, extent, and timing of planning varies with the entity's size and complexity, the auditor's experience with the entity, and the auditor's knowledge of the entity's operations. Procedures performed in the planning phase are shown in figure 200.1.

.02 A key to a quality audit, planning requires the involvement of senior members of the audit team. Although concentrated in the planning phase, planning is an iterative process performed throughout the audit. For example, findings from the internal control phase have a direct impact on planning the substantive audit procedures. Also, the results of control and substantive tests can require changes in the planned audit approach.

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220 - UNDERSTAND THE ENTITY'S OPERATIONS

.01 The auditor should obtain an understanding of the entity sufficient to plan and perform the audit in accordance with applicable auditing standards and requirements. In planning the audit, the auditor gathers information to obtain an overall understanding of the entity and its origin and history, size and location, organization, mission, business, strategies, inherent risks, the control environment, and internal controls. Understanding the entity's operations in the planning process enables the auditor to identify, respond to, and resolve accounting and auditing problems early in the audit.

.02 The auditor's understanding of the entity and its operations does not need to be comprehensive but should include:

- entity management and organization,
- external factors affecting operations,
- internal factors affecting operations, and
- accounting policies and issues.

.03 The auditor should identify key members of management and obtain a general understanding of the organizational structure. The auditor's main objective is to understand how the entity is managed and how the organization is structured for the particular management style.

.04 The auditor should identify significant external and internal factors that affect the entity's operations. External factors might include (1) source(s) of funds, (2) seasonal fluctuations, (3) current political climate, and (4) relevant legislation. Internal factors might include (1) size of the entity, (2) number of locations, (3) structure of the entity (centralized or decentralized), (4) complexity of operations, (5) qualifications and competence of key personnel, and (6) turnover of key personnel.

.05 In identifying accounting policies and issues, the auditor should consider

- applicable accounting principles and pronouncements, including whether the entity is likely to be in compliance;
- changes in principles that affect the entity; and
- whether entity management appears to follow aggressive or conservative accounting policies.

.06 The auditor should develop and document a high-level understanding of the entity's use of EDP and how EDP affects the generation of financial statement information and the data that support performance measures reported in the overview of the CFO report. An EDP audit specialist may assist the auditor in understanding the entity's use of EDP. Documentation of this understanding generally should include the following:

- the specific hardware and software comprising the computer configuration, including the type, number, and location of primary central processing units and whether any such units are interconnected;

- whether processing is primarily centralized or decentralized and whether data are entered only at processing locations or also at remote sites;

- the general nature of software utilities used at computer processing locations that provide the ability to add, alter, or delete information stored in data files, data bases, and program libraries;

- the general nature of software used to restrict access to programs and data at computer processing locations;

- significant computerized communications networks, interfaces to other computer systems, and the ability to upload and/or download information;

- the overall impact of microcomputers on the entity, including the

  - extent of integration of microcomputers in the accounting system (such as whether microcomputers are used to generate or process information for financial reporting),
  - relative number of microcomputers in use,
  - general nature of microcomputer use (such as word processing, spread sheets, or data base), and
  - adequacy of policies and procedures to control the access to microcomputers and use of software;

- the significant changes since any prior audits/reviews;

- the general types and extent of significant purchased software used;

- the general types and extent of significant software developed in-house;

- the method of data entry (interactive or noninteractive);
- the types of computer processing performed (stand alone, distributed, or networked);
- the use of service bureaus; and
- the approximate number of transactions processed by each significant system (as considered appropriate).

.07 The auditor gathers 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,
- Office of Inspector General (IG) and internal audit management (including any internal control officer),
- management of GAO divisions concerning completed, planned or in-progress assignments,
- personnel in OGC,
- personnel in OSI, and
- entity legal representatives.

.08 The auditor gathers information from relevant reports and articles issued by or about the entity, including

- financial statements;
- the entity's prior CFO reports, including the overview;
- FMFIA reports and supporting documentation;
- the entity's budget and related reports on budget execution;
- GAO reports;
- IG and internal audit reports;
- congressional hearings and reports;
- consultant reports; and
- material published about the entity in newspapers, magazines, and other publications.

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225 - PERFORM PRELIMINARY ANALYTICAL PROCEDURES

.01 During the planning phase, preliminary analytical procedures are performed to help the auditor

- understand the entity's business, including current-year transactions and events;
- identify account balances or transactions that may signal inherent or control risks (see section 260);
- identify and understand the significant accounting policies;
- determine planning, design, and test materiality (see section 230); and
- determine the nature, timing, and extent of audit procedures to be performed.

.02 GAAS requires the auditor to perform preliminary analytical procedures (AU 329). The resources spent in performing these procedures should be commensurate with the expected reliability of comparative information. For example, in a first-year audit, comparative information might be unreliable; therefore, preliminary analytical procedures generally should be limited.

.03 The auditor generally should perform the following steps to achieve the objectives of preliminary analytical procedures.

a. **Compare current-year amounts with relevant comparative financial information:** 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 budget or financial summaries that show the entity's financial position and results of operations may be used. Although the financial information on Treasury Standard Forms (SF) 220 (Report on Financial Position) and 221 (Report on Operations) is summarized at a very high level, it is adequate if no other available financial statements present more detail. The level of summarization of information used is a matter of the auditor's judgment.

The auditor compares current-year amounts with relevant comparative financial information. Use of unaudited comparative data might not allow the auditor to identify significant fluctuations,

particularly if an item consistently has been treated incorrectly. Also, the auditor may identify fluctuations that are not really fluctuations due to errors in the 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 detail 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 those derived from prior periods or budgets. The auditor does this to study the relationships among components of the financial statements and to increase knowledge of the entity's activities. The auditor uses ratios that are relevant indicators or measures for the entity. Additionally, the auditor should consider any trends in the performance indicators prepared by the entity.

b. **Identify significant fluctuations:** Fluctuations 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 identification of fluctuations is a matter of the auditor's judgment.

The auditor establishes parameters for selecting significant fluctuations. When setting these parameters, the auditor generally considers the amount of the fluctuation in terms of absolute size and/or the percentage difference. The amount and percentage used are left to the auditor's judgment. An example of a parameter is "All fluctuations in excess of $10 million and/or 15 percent of the prior-year balance or other unusual fluctuations will be considered significant."

c. **Inquire about significant fluctuations:** The auditor discusses the identified fluctuations with appropriate entity personnel. The focus of the discussion is to achieve the purposes of the procedures described in paragraph 225.01. For preliminary analytical procedures, the auditor does not need to corroborate the

explanations since they will be tested later. However, the explanations should appear reasonable and consistent to the auditor. The inability of entity personnel to explain the cause of a fluctuation may indicate the existence of control risks and/or inherent risks.

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230 - DETERMINE PLANNING, DESIGN, AND TEST MATERIALITY

.01 Materiality is one of several tools the auditor uses to determine that the planned nature, timing, and extent of procedures are appropriate. As defined in Financial Accounting Standards Board (FASB) Statement of Financial Concepts No. 2., materiality represents the magnitude of an omission or misstatement of an item in a financial report 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.

.02 Materiality is based on the concept that items of little importance, which do 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 types of misstatements could have a material impact on or warrant disclosure in the financial statements for qualitative reasons.

.03 For example, intentional misstatements or omissions (irregularities) usually are more critical to the financial statement users than are unintentional errors of equal amounts. This is because the users generally consider an intentional misstatement more serious than clerical errors of the same amount.

.04 GAGAS and incorporated GAAS require the auditor to consider materiality in planning, designing procedures, and considering need for disclosure in the audit report. AU 312 requires the auditor, in planning the audit, to consider his/her preliminary judgment about materiality levels. The Yellow Book states that materiality is a matter of professional judgment influenced by the needs of the reasonable person relying on the financial statements. Materiality judgments are made in the light of surrounding circumstances and involve both quantitative and qualitative considerations, such as the public accountability of the auditee and the visibility and sensitivity of government programs, activities, and functions.

.05 The term "materiality" can have several meanings. During the audit, the auditor uses the following terms that relate to materiality:

- **Planning materiality** is a preliminary estimate of materiality, in relation to the financial statements taken as a whole, used to determine the nature, timing, and extent of substantive audit procedures and to identify significant laws and regulations for compliance testing.

- **Design Materiality** is the portion of planning materiality that has been allocated to line items or accounts. This amount will be the same for all line items or accounts (except for certain offsetting balances as discussed in paragraph 230.10).

- **Test materiality** is the materiality actually used by the auditor in testing a specific line item or account. Based on the auditor's judgment, test materiality can be equal to or less than design materiality, as discussed in paragraph 230.13.

.06 The following other uses of the term "materiality" relate principally to the reporting phase:

- **Disclosure materiality** is the threshold for determining whether an item should be reported or presented separately in the principal statements or in the related notes. This value may differ from planning materiality.

- **FMFIA materiality** is the threshold for determining whether a matter meets OMB criteria for reporting matters under FMFIA as described in paragraphs 580.38-.40.

- **Reporting materiality** is the threshold for determining whether an unqualified opinion can be issued. In the reporting phase, the auditor considers whether unadjusted misstatements are quantitatively or qualitatively material. If considered to be material, the auditor would be precluded from issuing an unqualified opinion on the principal statements.

Unless otherwise specified, such as through using the terms above, the term "materiality" in this manual refers to the overall financial statement materiality as defined in paragraph 230.01.

.07 The following guidelines provide the auditor with a framework for determining planning materiality. However, this framework is not a substitute for professional judgment. The auditor has the flexibility to determine planning materiality outside of these guidelines. In such circumstances, the issue area director should discuss the basis for the determination with the Director of Planning and Reporting or designee. The planning materiality selected and method of determining planning materiality should be documented and approved by the issue area director.

.08 The auditor should estimate planning materiality in relation to the element of the combined (or consolidated) financial statements that is most significant to the primary users of the statements (the materiality base). The auditor uses judgment in determining the appropriate element of the financial statements to use as the materiality base. Also, since the materiality base normally is based on unaudited preliminary information determined in the planning phase, the auditor usually has to estimate the year-end balance of the materiality base. To provide reasonable assurance that sufficient audit procedures are performed, any estimate of the materiality base should be conservative. (If a range of estimates exists, the auditor should consider using the low end of the range to ensure that sufficient testing is performed.)

.09 For capital-intensive entities, total assets may be an appropriate materiality base. For expenditure-intensive entities, total expenses may be an appropriate materiality base. In considering a materiality base, the auditor generally should eliminate intergovernmental 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). Based on these concepts, the materiality base generally should be the greater of total assets or expenses (net of intergovernmental balances and offsetting balances). Other materiality bases that might be considered include total liabilities, equity, revenues, and net cost to the government (appropriations).

.10 The auditor may use separate planning materialities for offsetting balances. For an 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 may compute separate planning materiality for auditing the offsetting accounts, using the balance of the offsetting accounts as the materiality base.

.11 Planning materiality generally should be 3 percent of the materiality base. Although a mechanical means might be used to compute planning materiality, the auditor should use judgment in evaluating whether the computed level is appropriate. The auditor also should consider adjusting the materiality base for the impact of such items as unrecorded liabilities, contingencies, and other items that are not incorporated in the entity's financial statements (and not reflected in the materiality base) but that may be important to the financial statement user.

.12 Design materiality for the audit should be established as one-third of planning materiality to allow for the precision of audit procedures. This guideline recognizes that misstatements may occur throughout the entity's various accounts. The design materiality represents the materiality used as a starting point to design audit procedures for line items or accounts so that an aggregate material misstatement in the financial statements will be detected, for a given level of audit assurance (discussed in paragraph 260.04).

.13 Generally, the test materiality used for a specific test is the same as the design materiality. However, the auditor may use a test materiality lower than the design materiality for substantive testing of specific line items and assertions (which increases the extent of testing) when

- the audit is being performed at some, but not all, entity locations (requiring increased audit assurance for those locations visited - see section 285);

- the area tested is deemed to be sensitive to the financial statement users; or

- the auditor expects to find a significant amount of misstatements.

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235 - IDENTIFY SIGNIFICANT LINE ITEMS, ACCOUNTS, AND ASSERTIONS

.01 The auditor should identify significant line items and accounts and significant related financial statement assertions. In the internal control and testing phases, the auditor performs control and substantive tests for each significant assertion for each significant account. By identifying significant line items, accounts, and the related assertions early in the planning process, the auditor is more likely to design efficient audit procedures. Some insignificant line items, accounts, and assertions may not warrant substantive audit tests to the extent that they are not significant in the aggregate.

.02 Financial statement assertions, as defined by AU 326, 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 evidential matter concerning the assertions in such financial statements. The assertions can be either explicit or implicit and can be classified into the following broad categories:

- **Existence or occurrence:** An entity's assets or liabilities exist at a given date, and recorded transactions have occurred during a given period.

- **Completeness:** All transactions and accounts that should be presented in the financial statements are so included.

- **Rights and obligations:** Assets are the rights of the entity, and liabilities are the obligations of the entity at a given date.

- **Valuation or allocation:** Asset, liability, revenue, and expense components have been included in the financial statements at appropriate amounts.

- **Presentation and disclosure:** The particular components of the financial statements are properly classified, described, and disclosed.

.03 A line item or an account should be considered significant if it has one or more of the following characteristics:

- Its balance is material (exceeds design materiality) or comprises a significant portion of a material financial statement amount.

- A high combined risk (inherent and control risk, as discussed in paragraph 260.02) of material misstatement (either overstatement or understatement) is associated with one or more assertions relating to the line item or account.

- Special audit concerns, such as regulatory requirements, warrant added consideration.

The auditor should determine that any accounts considered insignificant are not significant in the aggregate.

.04 An assertion is significant if misstatements in the assertion could exceed test materiality for the related line item, account, or disclosure. 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 combined risk of material understatement even if its recorded balance is zero, and (2) the disclosure assertion could be significant for a contingent liability even if no amount is recordable.

.05 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.

- All assertions related to an account that is not significant (as defined in paragraph 235.03) are considered to be insignificant.

- The rights and obligations assertion for an income or expense account is irrelevant.

.06 Significant line items, accounts, and assertions should be identified in the Account Risk Analysis (ARA) or other appropriate audit planning workpapers.

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240 - IDENTIFY SIGNIFICANT CYCLES AND ACCOUNTING APPLICATIONS

.01 In the internal control phase, the auditor evaluates controls for each significant cycle and accounting application. A cycle or an accounting application should be considered significant if it processes an amount of transactions in excess of design materiality or if it supports a significant account balance. The auditor may identify other cycles or accounting applications as significant based on qualitative considerations.

.02 The entity's accounting system may be viewed as consisting of logical groupings of related transactions and activities, or accounting applications. Each significant line item/account is affected by input from one or more accounting applications (sources of debits or credits). Related accounting applications may be grouped into cycles by the auditor. 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. 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 an entity's recorded transactions and to maintain accountability for related assets and liabilities. Typical line item/account-related accounting applications include cash balances, accounts receivable, inventory control, property and equipment, and accounts payable.

.04 Within a given entity, there may be several examples of each accounting application. For example, a different billing application may exist for each program that uses a billing process. Accounting applications that process a related group of transactions and accounts comprise cycles. For instance, the billing, returns, cash receipts, and accounts receivable accounting applications might be grouped to form the revenue cycle.

.05 For each significant line item and account, the auditor should use the Account Risk Analysis form (see section 395 I) to document the significant transaction cycles (such as revenue, purchasing, and production) and the specific significant accounting applications that affect these significant line items and accounts. For example, the auditor might determine that billing,

returns, cash receipts, and accounts receivable are significant accounting applications that affect accounts receivable (a significant line item).

.06 Related accounting applications may be grouped into cycles to aid in preparing workpapers. This helps the auditor design audit procedures that are both efficient and relevant to the reporting objectives. The auditor may document insignificant accounts in each line item on the ARA, indicating their insignificance and consequent lack of audit procedures applied to them. In such instances, the cycle matrix may not be necessary. Otherwise, the auditor should prepare a cycle matrix 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.

.07 Based on discussions with entity personnel, the auditor should determine the accounting application that is the best source of the financial statement information. When a significant line item has more than one source of financial data, the auditor should consider the various sources and determine which is best for financial audit purposes. The auditor needs to consider 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.

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245 - IDENTIFY SIGNIFICANT PROVISIONS OF LAWS AND REGULATIONS

.01 To design relevant compliance-related audit procedures, the auditor identifies the significant provisions of laws and regulations. To aid the auditor in this process, this manual 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, the Prompt Payment Act requires 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, the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 prohibits the 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, the Single Audit Act requires the granting entity to review certain financial information on grantees.

.02 The auditor should identify the significant provisions of laws and regulations. For each significant provision, the auditor should study and evaluate related compliance controls and should test compliance with the provision. To identify such significant provisions, the auditor should take these steps:

a. The auditor should review the lists of laws and regulations that OMB and the entity have determined might be significant to others. The OMB list is provided in appendix B of OMB Bulletin 93-06 and is included in section 295 H. The entity is expected to develop a list that should include consideration of laws and regulations in OMB Bulletin 93-06. In addition, the auditor should identify (with OGC assistance) any laws or regulations (in addition to those identified by OMB and the entity) that have a direct effect on determining amounts in the financial

statements. The meaning of direct effect is discussed below in paragraph 245.03.

b. For each such law or regulation, the auditor should identify those provisions that are significant. A provision should be considered 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 material effect on determining financial statement amounts:

- **Transaction-based provisions:** Transactions processed by the entity that are subject to the provision exceed planning materiality in the aggregate.

- **Quantitative-based provisions:** The quantitative information required by the provision or by established restrictions exceed planning materiality.

- **Procedural-based provisions**: The provision broadly affects all or a segment of the entity's operations that processes transactions exceeding planning 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 consider whether the total amount of money granted exceeded planning materiality.

.03 A direct effect means that the provision specifies

- the nature and/or dollar amount of transactions that may be recorded (such as expenditure 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 annual financial statements (such as the statement of budgetary resources).

For example, entity-enabling legislation may contain provisions that limit the nature and amount of expenditures and therefore have a direct effect. 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 provision does not have a direct effect on determining financial statement amounts. Laws identified by the auditor that have a direct effect might include (1) new laws and regulations (not yet reflected on OMB's list) and (2) entity-specific laws and regulations. The concept of direct effect is discussed in AU 801 (SAS 74) and AU 317.

.04 In contrast, indirect laws relate more to the entity's operating aspects than to its financial and accounting aspects, and their financial statement effect is indirect. In other words, their effect may be limited to recording or disclosing liabilities arising from noncompliance. Examples of indirect laws and regulations include those related to environmental protection or occupational safety and health.

.05 The auditor is not responsible for testing compliance controls over or compliance with any indirect laws and regulations not otherwise identified by OMB or the entity (see paragraph 245.02.a.). However, as discussed in AU 317, the auditor should make inquiries of management regarding policies and procedures for the prevention of noncompliance with indirect laws and regulations. Unless possible instances of noncompliance with indirect laws or regulations come to the auditor's attention during the audit, no further procedures with respect to indirect laws and regulations are necessary.

.06 The auditor may elect to test compliance with indirect laws and regulations. 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 elect to test compliance with such laws and regulations. The auditor may also elect to test provisions of direct laws and regulations that do not meet the materiality criteria in paragraph 245.02.b. but that are deemed significant, such as laws and regulations that have generated significant interest by the Congress, the media, or the public.

.07 The significant provisions identified by the above procedures are intended to include provisions of all laws and regulations that have a direct and material effect on the determining of financial statement amounts and therefore comply with GAGAS, AU 801 (SAS 74), and OMB Bulletin 93-06.

250 - IDENTIFY RELEVANT BUDGET RESTRICTIONS

.01 To evaluate budget controls (see section 295 G) and to design compliance-related audit procedures relevant to budget restrictions, the auditor should understand the following information (which may be obtained from the entity or OGC):

- the Antideficiency Act (title 31 of the U.S. Code, sections 1341, 1342, 1349-1351, 1511-1519);
- the Purpose Statute (title 31 of the U.S. Code, section 1301);
- the Time Statute (title 31 of the U.S. Code, section 1502);
- OMB Circular A-34;
- GAO title 7;
- the Impoundment Control Act;
- the Federal Credit Reform Act of 1990; and
- budgetary accounting concepts and terminology, as found in Basic Topics Relating to Appropriations and Reimburseables (GAO/AFMD-PPM-2.1).

.02 The auditor should read the following information relating to the entity's appropriation (or other budget authority) for the period of audit interest:

- authorizing legislation;
- enabling legislation and amendments;
- appropriation legislation and supplemental appropriation legislation;
- 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 system of fund controls document approved by OMB; and
- any other information deemed by the auditor 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 (i.e., why the entity has undertaken certain activities and the objectives of these activities).

.03 Through discussions with OGC and the entity and by using the above information, the auditor should identify all legally binding restrictions on the entity's use of appropriated funds that are relevant to budget execution, such as restrictions on the amount, purpose, or timing of obligations and expenditures ("relevant budget restrictions"). Additionally, the auditor should consider any legally binding restrictions that the entity has established in its fund control regulations, such as lowering the legally binding level for compliance with the Antideficiency Act to the allotment level.

.04 The auditor should obtain an understanding of the implications if the entity were to violate these relevant budget restrictions. In the internal control phase, the auditor identifies and tests the entity's controls to prevent or detect noncompliance with these relevant restrictions. The auditor may elect to evaluate controls over budget restrictions that are not legally binding but that may be considered sensitive or otherwise 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 those entities that do 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 legislation that created the entity (such as the authorizing and enabling legislation) 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 the Antideficiency Act) apply to government corporations but not to government-sponsored enterprises. Regardless, the auditor should consider the entity's budget formulation and execution as part of the control environment, as discussed in section 260.

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260 - ASSESS INHERENT RISK AND THE CONTROL ENVIRONMENT

.01 The auditor's assessment of inherent risk and the control environment affects the nature, timing, and extent of substantive and control tests. This section describes (1) the impact of inherent risk and the control environment on substantive and control tests, (2) the process for assessing inherent risk and the control environment (including factors to consider), and (3) the auditor's consideration of the entity's process for reporting under FMFIA and for formulating the budget.

IMPACT ON SUBSTANTIVE TESTING

.02 AU 316 requires the auditor to assess the risk that errors and irregularities may cause a material misstatement in the financial statements. AU 312 defines "audit risk" as the risk that the auditor may unknowingly fail to appropriately modify an opinion on financial statements that are materially misstated. Audit risk can be thought of in terms of the following three component risks:

- **Inherent risk** is the susceptibility of an assertion to a material misstatement, assuming that there are no related internal controls.

- **Control risk** is the risk that a material misstatement that could occur in an assertion will not be prevented, or detected and corrected on a timely basis by the entity's internal control structure. The internal control structure consists of (1) the control environment, (2) the accounting system, and (3) control techniques.

- **Detection risk** is the risk that the auditor will not detect a material misstatement that exists in an assertion.

.03 Based on the level of audit risk and an assessment of the entity's inherent and control risk, the auditor determines the nature, timing, and extent of substantive audit procedures necessary to achieve the resultant detection risk. For example, in response to a high level of inherent and control risk, the auditor performs

- additional audit procedures that provide more competent evidential matter (nature of procedures);

- substantive tests at or closer to the financial statement date (timing of procedures); or
- more extensive substantive tests (extent of procedures), as discussed in section 295 E.

.04 Audit assurance is the complement of audit risk. The auditor can determine the level of audit assurance obtained by subtracting the audit risk from 1. (Assurance equals 1 minus risk). For audits of federal entities, the auditor must design the audit to achieve at least 95 percent audit assurance that the financial statements are not materially misstated (5 percent audit risk). Section 470 discusses how the auditor combines (1) the assessment of inherent and control risk and (2) substantive tests to achieve 95 percent assurance.

.05 The auditor may consider it necessary to achieve audit assurance above 95 percent if the entity is politically sensitive or if the Congress has expressed concerns about the entity's financial reporting. If other than 95 percent, the level of audit assurance should be approved by the Director of Planning and Reporting.

IMPACT ON CONTROL TESTING

.06 In this manual, internal controls (sometimes referred to as management controls) are broken down into the following categories:

- **Financial reporting controls,** as identified in AU 319 (SAS 55), are the policies and procedures that pertain to an entity's ability to record, process, summarize, and report financial data consistent with the assertions in the financial statements. (Note that safeguarding controls (see 310.02-.04) are considered as part of financial reporting controls.)

- **Budget controls** are the policies and procedures used to manage and control the use of appropriated funds and other forms of budget authority. These controls are described in more detail in Section 295 G.

- **Compliance controls** are the policies and procedures management uses to comply with laws and regulations.

- **Operations controls** relate to managing the entity's business. These controls include policies and procedures to carry out organizational objectives, such as planning, productivity, programmatic, quality,

economy, efficiency, and effectiveness objectives. Management uses these controls to provide reasonable assurance that the entity (1) meets its goals, (2) maintains quality standards, and (3) does what management directs it to do. Operations controls also include performance measures controls, which are policies and procedures designed to provide reasonable assurance that data supporting reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

.07 Some control policies and procedures belong in more than one category of controls. For example, financial reporting controls include controls over the completeness and accuracy of inventory records. Such controls are also necessary to provide complete and accurate inventory records to allow management to analyze and monitor inventory levels to better control operations and make procurement decisions (operations controls).

.08 The control environment is a factor in assessing controls in all four categories discussed above. The control environment represents the collective effect of various factors (see paragraph 260.18) on establishing, enhancing, or mitigating the effects of specific control techniques. The control environment sets the "tone at the top" of an entity. A weak control environment can render otherwise effective control techniques ineffective.

PROCESS FOR ASSESSING INHERENT RISK AND THE CONTROL ENVIRONMENT

.09 In the planning phase, the auditor assesses inherent risk and the control environment. The auditor should (1) identify conditions that significantly increase inherent and control risk (based on identified control environment weaknesses) and (2) conclude whether the control environment precludes the effectiveness of specific control techniques in significant applications. The auditor identifies specific inherent risks and control environment weaknesses based on information obtained earlier in the planning phase, primarily from understanding the entity's operations and preliminary analytical procedures. The auditor considers factors such as those listed in paragraphs 260.16-.27 in identifying such risks and weaknesses. These factors are general in nature and require the auditor's judgment in determining (1) the extent of procedures to identify the risks and weaknesses and (2) the impact of such risks and weaknesses on the entity and its financial statements. Because this risk assessment requires the exercise of significant audit judgment, it should be performed by experienced audit team personnel.

.10 The auditor considers the implications of these inherent risks and control environment weaknesses 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 weaknesses in such operations controls could significantly affect the ultimate program cost. Therefore, the need for operations controls in a particular area or the awareness of operations controls weaknesses related to inherent risk or the control environment should be identified and considered for further review, as discussed in section 275.

.11 Specific conditions that may indicate inherent risks or control environment weaknesses are provided in sections 295 A and 295 B, respectively. These sections are designed to aid the auditor in identifying these risks and weaknesses but are not intended to be all inclusive. The auditor should consider any other factors and conditions deemed relevant.

.12 The auditor identifies and documents any significant inherent risks and control environment weaknesses after considering (1) his/her knowledge of the entity (obtained in previous steps in the planning phase); (2) the inherent risk and control environment factors discussed in paragraphs 260.16-.27; (3) the potential inherent risk conditions and control environment weaknesses listed in sections 295 A and 295 B, respectively; and (4) other relevant factors. These risks and weaknesses and their impact on proposed audit procedures should be documented on the General Risk Analysis (GRA). The auditor also should summarize and document any account-specific risks on the Account Risk Analysis.

.13 For each inherent risk or control environment weakness identified, the auditor documents the nature and extent of the risk or weakness; the condition(s) that gave rise to that risk or weakness; and the specific cycles, accounts, line items, and related assertions affected (if not pervasive). For example, the auditor may identify a significant risk that the valuation of the net receivables line item could contain a material misstatement due to (1) the materiality of the receivables and potential allowance, and (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

weaknesses. For example, the use of a lock box (a control procedure) may mitigate inherent risks associated with completeness of cash receipts.

.14 The auditor also should document the overall effectiveness of the control environment, including whether that environment precludes the effectiveness of specific control techniques in the GRA. The focus should be on management's overall attitude, awareness, and actions, rather than on specific conditions related to a control environment factor. This assessment will be considered when determining the control risk associated with the entity.

.15 In assessing the control environment, the auditor should specifically assess the quality of the entity's process for compliance with FMFIA (see paragraphs 260.22-.26) and should obtain an overall understanding of the budget formulation process (see paragraph 260.27).

INHERENT RISK FACTORS

.16 Inherent risk factors incorporate characteristics of an entity, a transaction, or account that exist due to

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

The assessment of inherent risk generally should be limited to significant programs, transactions, or accounts. For each factor listed below, section 295 A lists conditions that may indicate inherent risk.

a. **Nature of the entity's programs:** The mission/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 irregularities and sensitivity to changes in economic conditions. For example, student loan guarantee programs may be more susceptible to errors and irregularities 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, IG audits, or other audits often identify problem areas that may result in financial statement misstatements. For example, the prior year's audit may have

identified the necessity for recording a contingent liability as the result of certain economic conditions. The auditor then could focus on

- determining whether similar conditions continue to exist;
- understanding management's response to such condition (including implementation of controls), if any; and
- assessing the nature and extent of the related inherent risk.

c. **Nature of material transactions and accounts:** The nature of an entity's transactions and accounts has a direct relation to the risk of errors or irregularities. For example, accounts involving subjective management judgments, such as loss allowances, are usually of higher risk than those involving objective determinations.

EDP EFFECTS ON INHERENT RISK

.17 EDP, in itself, does not affect the audit objectives for an account or a cycle. However, it can introduce inherent risk factors not present in a manual accounting system. The auditor should (1) consider each of the following EDP-related factors and (2) assess the overall impact of EDP on inherent risk. The impact of these factors typically will be pervasive in nature. An EDP audit specialist may assist the auditor in considering these factors and making this assessment.

a. **Uniform processing of transactions:** Because EDP processes groups of identical transactions consistently, any misstatements arising from erroneous EDP programming will occur consistently in similar transactions. However, the possibility of random processing errors is reduced substantially in EDP-based accounting systems.

b. **Automatic processing:** The EDP 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 computer programs and data are not readily detectible. Also, users may be less likely to challenge the reliability of EDP output than manual reports.

d. **Existence, completeness, and volume of the audit trail:** The audit trail is the evidence that demonstrates how a specific transaction was initiated, processed, 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, and/or account); and general ledger postings from the invoice register. Some EDP financial management systems are designed so that the audit trail exists for only a short period (such as in on-line systems), only in an electronic format, or only in summary form. Also, the information generated may be too voluminous to effectively follow the audit trail. For example, one posting to the general ledger may result from the EDP summarization of information from hundreds of locations. Without a hard copy audit trail, tracing transactions through EDP processing may be extremely difficult.

e. **Nature of the hardware and software used in EDP:** The nature of the hardware and software can affect inherent risk, as illustrated below:

- The type of computer processing (on-line, 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 on-line processing than for batch-oriented processing.

- Peripheral access devices or system interfaces can increase inherent risk. For example, dial-up access to a system increases the system's accessibility to additional persons and therefore increases 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 EDP data between multiple processing units.

- Applications software developed in-house may have higher inherent risk than vendor-supplied software that has been thoroughly tested and is in general commercial use.

f. **Unusual or nonroutine transactions:** As with manual systems, unusual or nonroutine 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.

CONTROL ENVIRONMENT FACTORS

.18 As discussed in AU 319 (SAS 55), control environment risk factors incorporate management's attitude, awareness, and actions concerning the entity's control environment. These factors include

- management's philosophy and operating style,
- the entity's organizational structure,
- methods of assigning authority and responsibility,
- management's control methods for monitoring and following up on performance,
- the effectiveness of the IG and internal audit,
- personnel policies and practices,
- influences external to the entity,
- management's control methods over budget formulation and execution,
- management's control methods over compliance with laws and regulations,
- management's ability to promptly identify and react to changing conditions, and
- the functioning of oversight bodies (including congressional committees).

.19 The auditor should obtain sufficient knowledge of the control environment to determine whether the collective effect of these factors establishes, enhances, or mitigates the effectiveness of specific control techniques. In making this determination, the auditor should consider the following factors and their effect on the internal controls. For each factor listed below, section 295 B lists conditions that may indicate control environment weaknesses.

a. **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, and emphasis on meeting financial and operating goals.

b. **The entity's organizational structure:** An entity's organizational structure provides the overall framework for planning, directing, and controlling operations. The organizational structure should appropriately assign 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.

c. **Methods of assigning 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.

d. **Management's control methods for monitoring and following up on performance:** These control methods affect management's (1) direct control over the exercise of authority delegated to others and (2) ability to supervise overall entity activities.

e. **The effectiveness of the IG and internal audit:** An IG's office is responsible for (1) conducting and supervising audits and investigations relating to programs and operations, (2) providing leadership and coordination, including recommending policies for programs and operation, and (3) keeping the entity head and the Congress informed about problems and deficiencies, including progress of corrective actions. Evaluating an IG's office includes consideration of its authority and reporting relationships, the qualifications of its staff, and its resources. Similar concepts apply to internal auditors.

f. **Personnel policies and practices:** Personnel policies and practices affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Such policies and practices include hiring, training, evaluating, promoting, compensating, and assisting employees in the performance of their assigned responsibilities by giving them the necessary resources.

g. **Influences external to the entity:** Influences outside an entity's authority may affect its operations and practices. Such influences include monitoring and compliance requirements imposed by legislative bodies, general business conditions, and other economic factors. The existence of such influences generally heightens the need for a strong control environment.

h. **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 paragraph 260.28, and controls over budget execution (budget controls) are addressed in more detail in section 300.

i. **Management's control methods over compliance with laws and regulations:** Such methods have a direct impact on an entity's compliance with applicable laws and regulations. (Compliance controls are addressed in more detail in section 300).

j. **Management's ability to promptly identify and react to changing conditions:** Since conditions external to and within an entity will continue to change, management's ability to identify and react to such changes can affect achievement of the entity's objectives. The extent to which such changes require management's attention depends on the effect they may have in the particular circumstances.

k. **The functioning of oversight bodies:** An entity's oversight bodies typically are responsible for overseeing both business activities and financial reporting. The effectiveness of an oversight body is influenced by its authority and its role in overseeing the entity's business activities.

EDP EFFECTS ON THE CONTROL ENVIRONMENT

.20 EDP also affects the effectiveness of the control environment. For example, controls that normally would be performed by separate individuals in manual systems may be concentrated in one EDP application and pose a potential segregation-of-duties problem.

.21 The auditor should consider the following EDP-related factors in making an overall assessment of the control environment. An EDP audit specialist may assist the auditor in considering these factors:

a. **Management's attitudes and awareness with respect to EDP:** Management's interest in and awareness of EDP functions is important in establishing an organizationwide control consciousness. Management may demonstrate such interest and awareness by

- considering the risks and benefits of computer applications;

- communicating policies regarding EDP functions and responsibilities;
- overseeing policies and procedures for developing, modifying, maintaining, and using computers and for controlling access to programs and files;
- considering the inherent and control risk related to EDP;
- responding to previous recommendations or concerns;
- quickly and effectively planning for, and responding to, computerized processing crises; and
- depending on computer-generated information for key operating decisions.

b. **Organization and structure of the EDP function:** The organizational structure affects the control environment. Centralized structures often have a single computer processing organization and use a single set of system and applications software, enabling tighter management control over EDP. In decentralized structures, each computer generally has its own computer processing organization, application 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 EDP functional areas can affect the control environment. Factors to consider include

- how the position of the director of the EDP function fits into the organizational structure;
- whether duties are appropriately segregated within the EDP function, since lack of segregation typically affects all systems;
- the extent to which management external to the EDP function is involved in major systems development decisions; and
- the extent to which policies, standards, and procedures are documented, understood, followed, and enforced.

d. **Management's ability to identify and to respond to potential risk:** EDP 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 EDP issues that might occur. Factors to consider include

- 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.

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.22 In considering the control environment, the auditor should assess the quality of the FMFIA process to provide evidence of management's control consciousness and the overall quality of the control environment. In this regard, the quality of the FMFIA process is a good indicator of management's (1) philosophy and operating style, (2) methods of assigning authority and responsibility, and (3) control methods for monitoring and follow-up. The FMFIA process also may be the basis for management's assertion about the effectiveness of internal controls. If the entity does not issue its own FMFIA report, the auditor should perform the following procedures with respect to information the entity contributes to the FMFIA report in which the entity is included.

.23 In considering the quality of the FMFIA process, the auditor generally should:

- Read
  - the FMFIA report,
  - workpapers prepared by the entity in support of the FMFIA report,
  - IG reports on FMFIA compliance,
  - 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 their opinion of the quality of the process).

- Understand
  - 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 weaknesses.

- Identify the entity's actions on previously reported weaknesses and examine agency documentation that demonstrates the results/effectiveness of those actions.

.24 In assessing the quality of the FMFIA process, the auditor should consider whether management procedures and supporting documentation are sufficient to (1) provide management with reasonable assurance that FMFIA objectives have been achieved and (2) meet OMB requirements. This assessment is based on the auditor's overview and is not a result of extensive tests. Factors for the auditor to consider may 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 conform to the guidance in Circulars A-123 (June 21, 1995) and A-127 (July 23, 1993) and related OMB guidelines;

- IG and 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; and

- the sources of identification of material weaknesses, since items identified by management personnel, rather than from IG, GAO, or other external reports, demonstrate that the process can detect and report weaknesses.

.25 The auditor's assessment of the quality of the FMFIA process will affect the auditor's ability to use information in the FMFIA report and supporting documentation when identifying risks, testing controls, and preparing workpapers. The higher the quality of the FMFIA process, the more likely the auditor will be able to incorporate the FMFIA documentation or findings into the financial audit. The auditor should document the assessment of the quality of the FMFIA process in the audit workpapers. Regardless, any material weaknesses identified in the FMFIA report should be considered in assessing risk.

.26 The reliance that the auditor places on management's FMFIA work depends on the independence of the FMFIA personnel and the other factors discussed in AU 322 (SAS 65), "The Auditor's Consideration of the Internal Audit Function in an Audit of the Financial Statements." As with using an internal auditor's work, management's FMFIA work is not a substitute for the financial statement auditor's work. All judgments of the effectiveness of the internal controls, sufficiency of the tests performed, materiality of transactions, and other matters affecting the report on the financial statements must be those of the auditor.

BUDGET FORMULATION

.27 While assessing the control environment, the auditor should obtain an overall understanding of the budget formulation process. The auditor does this to understand better how misstatements and internal control weaknesses affect the budget formulation process and, possibly, to consider the budget process as a control. Based on discussions with entity management responsible for the budget formulation process and review of budget documents, the auditor should understand

- 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 that 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 in the budget execution system.

270 - DETERMINE LIKELIHOOD OF EFFECTIVE EDP-RELATED CONTROLS

.01 Controls are EDP-related if their effectiveness depends on computer processing. In the planning phase, the auditor (with the assistance of the EDP audit specialist) should determine whether EDP-related controls are likely to be effective and should therefore be considered in the internal control phase. The procedures to be performed build on those procedures performed while understanding the entity's operations and assessing the effects of EDP on inherent risk and the control environment. AU 319 (SAS 55) requires the auditor to sufficiently understand each of the three elements of the internal controls — the control environment, the accounting system, and control techniques — to plan the audit. This understanding should include relevant EDP aspects.

.02 Computerized financial management systems are used extensively in the federal government. While many of these systems are mainframe based, numerous minicomputer and microcomputer systems also exist. Some of these systems share programs and data files with one another. Others may be networked into major subsystems. In addition to producing financial and accounting information, such systems typically generate other information used in management decision-making.

.03 As discussed in paragraph 260.06, the auditor evaluates and tests the following types of controls in a financial statement audit:

- financial reporting controls,
- budget controls,
- compliance controls, and
- certain operations controls (to the extent described in FAM 275).

.04 For each of the controls to be evaluated and tested, the auditor should distinguish EDP-related controls. Testing of technical EDP-related controls should be performed by an EDP audit specialist as described in section 360. The audit team may assist the EDP audit specialist by testing user controls and application controls involving manual follow-up. EDP-related controls can be classified into three types (described in section 295 F):

- general controls,
- application controls, and
- user controls.

.05 In the planning phase, the auditor and the EDP audit specialist should understand each of the three types of EDP-related controls to the extent necessary to tentatively conclude whether EDP-related controls are likely to be effective. If they are likely to be effective, the auditor should consider specific EDP-related controls in determining whether control objectives are achieved (in the internal control phase).

.06 If EDP-related controls are not likely to be effective, the auditor (with the assistance of the EDP audit specialist) should obtain a sufficient understanding of control risks arising from EDP to develop appropriate findings and to plan substantive testing. Also, in the internal control phase, the auditor generally should focus on the effectiveness of manual controls in achieving control objectives. If EDP-related controls are not likely to be effective due to poor general controls <u>and</u> if manual controls do not achieve the control objectives, the auditor should identify and evaluate, but not test, any <u>specific</u> EDP-related controls that are designed to achieve the control objectives (to provide recommendations to improve internal controls).

.07 In the planning phase, the auditor and the EDP audit specialist generally limit the understanding of general controls to those at an overall entity level. However, obtaining this understanding generally requires visits to selected installations. General controls related to an installation level and to specific applications will be considered in more detail in the internal control phase. In assessing general controls, the auditor and the EDP audit specialist should consider the results of past internal and external reviews.

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275 - IDENTIFY RELEVANT OPERATIONS CONTROLS TO EVALUATE AND TEST

.01 The overall intent of the CFO Act is to improve the quality of federal financial management. Reliable financial information and effective internal controls are important to the quality of such federal financial management. In a financial statement audit, the auditor draws a conclusion about the effectiveness of certain financial reporting (including safeguarding), budget execution, and compliance controls and compares this conclusion with management's assertion about the effectiveness of internal controls to form an opinion on the assertion. While the auditor does not form an opinion on operations controls, the auditor

- may evaluate certain operations controls considered relevant (see paragraphs 275.02-.07),
- should evaluate and test operations controls that are relied on in performing audit procedures (see paragraph 275.08), and
- should understand internal controls over the performance measures reported in the overview of the CFO report and assess the design of the controls and whether they have been placed in operation, but does not need to test those controls, according to OMB Bulletin 93-06 (see paragraph 275.09).

RELEVANT OPERATIONS CONTROLS

.02 For potential operations control needs of the entity or for operations control weaknesses identified through the procedures described in paragraphs 275.04-.07, the auditor should determine whether the evaluation of related controls should (1) be included in the financial audit, (2) be tested by another GAO division, (3) become a separate audit or (4) not be performed, but any weaknesses be reported to the IG. In making this determination, the auditor might consider the following factors:

- the significance of the operations control to the entity's operations,
- the time required to identify and test the operations control,
- available resources, and
- congressional interest.

.03 Audit team management should agree on the operations controls that are to be evaluated and tested as part of the financial audit. Such operations

controls should be documented in the workpapers. For example, audit management may require that before evaluating and testing a specific operations control, the audit team submit relevant information to audit management on a standard form developed by the audit team.

.04 In the planning phase and throughout the audit, the auditor generally should 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 weaknesses in operations controls, through:

- understanding the entity's operations;
- planning the audit procedures;
- understanding audit risks and weaknesses in financial reporting, budget, and compliance controls;
- understanding the cause of misstatements noted; or
- observations made during on-site fieldwork.

.05 In obtaining an understanding of the entity's operations, the auditor should identify those areas that are critical to such 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, the auditor may evaluate whether management considered appropriate order quantities for each inventory purchase selected in a test of inventory purchases.

.06 The auditor identifies specific risks and weaknesses in planning and performing the audit and in determining the causes of misstatements requiring audit adjustments. The auditor should consider the implications of those risks and weaknesses on the entity's operations controls. For example, misstatements in inventory records may indicate weaknesses in operations controls whose effectiveness depends on accurate inventory records. This would include the operations controls for maintaining proper inventory levels.

.07 The auditor should be alert to any opportunities to recommend improvements to operations controls. Such opportunities could come to light while visiting the entity's various locations and performing the financial audit.

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 will need to identify and test the entity's operations controls over the production of these internal statistics.

OPERATIONS CONTROLS OVER REPORTED PERFORMANCE MEASURES

.09 OMB Bulletin 93-06 requires the auditor to understand internal controls over the existence, completeness, and valuation (see definition in paragraph 235.02) assertions related to the performance measures the entity reports on in the overview of the CFO report and assess the design of the controls and whether they have been placed in operation. However, OMB does not require the auditor to test the controls (determine operating effectiveness), although he or she may decide to do so. OMB intends to expand the auditor's responsibilities in this area in the future.

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280 - PLAN OTHER AUDIT PROCEDURES

.01 The auditor should consider the following areas during the planning phase, even though related audit procedures will be applied during the other phases.

INQUIRIES OF ATTORNEYS

.02 As discussed in AU 337 and section 550, the auditor should make inquires of the entity's counsel and perform other audit procedures regarding litigation, claims, and assessments. Because of the amount of the time needed by management and the attorneys to gather and report the necessary information, the auditor should plan the following procedures (which are described in more detail in AU 337) for an appropriate point in the audit

- making inquiries of management regarding their policies and procedures used for identifying, evaluating, and accounting for litigation, claims, and assessment;

- 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 end of fieldwork);

- obtaining evidence regarding attorneys used by the entity and matters handled;

- sending letters of audit inquiry to attorneys

MANAGEMENT REPRESENTATIONS

.03 As discussed in section 550, the auditor is required to obtain a representation letter from management on specific matters prior to completion of the audit. Particularly during first year audits, the auditor may want to discuss these required representations with management early in the audit to identify and resolve any difficulties related to obtaining these representations. Additional guidance on management representations is provided in AU 333, AU 801, SSAE 2, and section 1001 (Part II).

RELATED PARTY TRANSACTIONS

.04 AU 334 provides guidance on audit procedures that should be performed to identify related parties and related transactions as well as examining these transactions for appropriate disclosure in the financial statements. During the planning phase, the auditor should perform procedures to identify and document related parties and the nature of related party transactions that might need to be disclosed in the principal statements and related notes. Such information should be distributed to all members of the audit team for use in summarizing and testing related party transactions and identifying any additional related parties.

SENSITIVE PAYMENTS

.05 Sensitive payments, as described in AFMD technical guideline 8.1.2 "Guide for Review of Sensitive Payments," encompass a wide range of executive functions including executive compensation, travel, official entertainment funds, unvouchered expenses, and consulting services. In the planning phase, the auditor should consider the audit procedures that will be applied to sensitive payments.

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285 - PLAN LOCATIONS TO VISIT

.01 Most federal entities conduct operations, perform accounting functions and/or retain records at multiple locations. During planning, the auditor needs to consider the effect of these multiple locations on the audit approach. The auditor should develop an understanding of the respective locations, including significant accounts and accounting systems and cycles/applications. This understanding may be obtained centrally or in combination with visits to field offices, as appropriate. When planning locations to visit, the auditor should consider the following factors:

- **Materiality or significance of locations to the overall entity:** More material locations, particularly those individually exceeding design materiality, and significant cycles/accounting applications may require more extensive testing.

- **The results of the preliminary analytical procedures applied during planning:** Unusual results require follow-up, possibly including on-site testing at specific locations causing such results.

- **The results and the extent of audit procedures applied in prior years by GAO or others, including the time since significant procedures were performed:** Problems noted in prior audits could indicate areas of concern for the current audit, and the effectiveness of prior evidence ordinarily diminishes with the passage of time.

- **The auditor's assessment of inherent risk, 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.

- **The auditor's preliminary assessment of control risk, including the control environment:** Locations at which control risk (particularly concerning the control environment) is high warrant more extensive testing than those where control risk is low.

- **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.

- **The extent of uniformity of control systems (including EDP 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, more locations may require visits than for those entities using centrally developed systems.

- **The extent of work performed by the IG or others:** Work done by the IG or others may be used to reduce or eliminate tests at selected locations or to assist in tests of locations not selected.

- **Special reporting or entity requirements:** The auditor should select sufficient locations to meet special needs, such as separate-location reports.

.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 test materiality and control effectiveness. Using common audit programs, workpaper formats, and indexes for the various locations visited makes it easier to plan, to review the workpapers, and to combine the results of all locations or funds to improve effectiveness and efficiency.

.03 The auditor should obtain an understanding 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 any necessary adjustments and eliminations.

.04 One approach to stratifying the locations and selecting samples for multiple-location audits is provided in section 295 C. Other methods of selecting locations for on-site testing may be used with the approval of the Director of Planning and Reporting or designee. 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 will require more overall audit testing than the method described in section 295 C, the costs of performing additional work at fewer locations may be lower.

290 - DOCUMENTATION

.01 The auditor should document relevant information obtained during the planning phase in the documents described in paragraphs 290.03-.06. Information that is likely to be useful in future audits may be documented in a permanent file to be carried forward.

.02 As the audit work is performed, the auditors may become aware of possible reportable conditions or other matters which should be communicated to the auditee. A structured method to document these matters will aid in communicating them to the audit team, to management for review, and to the agency soon after their discovery. The auditor generally should document the nature of the reportable condition and the criteria, cause, potential effect, and suggestions for improvement (as applicable) throughout the audit and discuss them with management when identified, rather than waiting until the exit conference.

.03 **In the entity profile or an equivalent document,** the auditor should document the information gathered to gain an understanding of the entity (section 220). This profile should briefly document such elements as the entity's origin and history, size and location, organization, mission, results of prior and current audits, and accounting and auditing considerations. 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.

.04 The **General Risk Analysis** contains the overall audit plan, including the strategy for conducting the audit, and also should include information on the following areas:

a. **Preliminary analytical procedures and the results of those procedures (section 225):** The auditor should document the following information:

- data used and sources of financial data used 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 (i.e. SF 220, the general ledger trial balance, prior-year audit workpapers, or prior-year financial statements);

- parameters for identifying significant fluctuations;

- explanations for fluctuations identified and sources of these explanations, including the name and title of the person(s) from whom the explanations were obtained; and

- the auditor's conclusion and consideration of the impact of the results of preliminary analytical procedures on the audit.

b. **Planning, design, and test materiality, including the basis for their determination (section 230).**

c. **Significant provisions of laws and regulations (section 245).**

d. **Relevant budget restrictions (section 250).**

e. **Assessment of inherent risk and the overall effectiveness of the control environment, including whether the control environment precludes the effectiveness of specific control techniques (section 260):** The auditor identifies and documents any inherent risks or control risks arising from the control environment and associates them with significant financial statement line items and assertions. For each risk identified, the auditor documents 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 also documents conclusions on the overall effectiveness of the control environment.

f. **Effects of EDP:** The auditor should document

- a basic understanding of the EDP aspects of the financial management system, including the significance of EDP to the entity (section 220);
- the inherent risks arising from EDP (paragraph 260.17);
- the impact of EDP on the control environment (paragraphs 260.20-.21); and

- tentative conclusions on the likelihood that EDP-related controls are operating effectively (section 270).

When the auditor prepares documentation of the above information, the EDP audit specialist generally should review and agree with the content. Tentative conclusions on the likelihood that EDP-related controls are operating effectively should also be reviewed and concurred in by the issue area director and an assistant director as part of their review of the General Risk Analysis. If EDP-related controls are not likely to be effective, the auditor should document supporting evidence and generally should report such findings as discussed in section 580.

g. **Operations controls to be tested, if any (section 275).**

h. **Other planned audit procedures (section 280).**

i. **Locations to be visited (section 285):** This information includes

- the locations selected,
- the basis for selections,
- the general nature of procedures planned for each location,
- the determination of the number of items for testing,
- the allocation of those items among the selected locations, and
- other procedures applied.

j. **Staffing requirements.**

k. **Audit timing, including milestones.**

l. **Assistance from entity personnel.**

.05 The **Cycle Matrix** links each of the entity's accounts (in the chart of accounts) to a cycle, an accounting application, and a financial statement line item (paragraph 240.06). This information may also be incorporated into the Account Risk Analysis.

.06 The **Account Risk Analysis** contains the audit plan for each significant line item and account and should identify significant line items, accounts, assertions, and cycles/accounting applications (sections 235 and 240, respectively). The auditor also summarizes and documents the specific risks, other than pervasive risks, for use in determining the nature, timing, and extent of the audit procedures. The auditor may also include

insignificant accounts in each line item ARA, indicating their insignificance and consequent lack of audit procedures applied to them. In such instances, the cycle matrix should not be prepared. AIMD has developed a computer system for preparing ARA and SCE forms which is available from the Microcomputer Support Group, as are templates for the forms in WordPerfect 5.1.

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295 A - POTENTIAL INHERENT RISK CONDITIONS

.01 The specific conditions listed below may indicate the presence of inherent risks. This section is designed to aid the auditor in considering each of the inherent risk factors described in paragraph 260.17 but is not intended to be all inclusive. The auditor should consider any other factors and conditions considered relevant.

.02 **NATURE OF THE ENTITY'S PROGRAMS**

- Programs are significantly affected by new/changing governmental regulations, economic factors, and/or environmental factors.
- Contentious or difficult accounting issues are associated with the administration of a significant program(s).
- Major uncertainties or contingencies, including long-term commitments, relate to a particular program(s).
- 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, lack adequate systems to measure performance, and generally have considerable confusion associated with them.
- Programs that are phasing out (to be eliminated within 1 or 2 years) lack adequate resources, lack personnel motivation and interest, or involve closeout activities for which controls have not been developed.
- Significant programs have a history of improper administration, affecting operating activities.
- Significant programs have minimal IG or internal audit coverage.

.03 **HISTORY OF SIGNIFICANT AUDIT ADJUSTMENTS**

- The underlying cause of significant audit adjustments continues to exist.

.04 **NATURE OF MATERIAL TRANSACTIONS AND ACCOUNTS**

- New types of transactions exist.

- Significant transactions or accounts have minimal IG or internal audit coverage.

- Significant related and/or third party transactions exist.

- Classes of transactions or accounts have one or more of the following characteristics:

  - 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.

- Accounts have complex underlying calculations or accounting principles.

- Accounts in which the underlying activities, transactions, or events are operating under severe time constraints.

- Accounts in which activities, transactions, or events involve the handling of unusually large cash receipts, cash payments, or wire transfers.

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295 B - POTENTIAL CONTROL ENVIRONMENT WEAKNESS CONDITIONS

.01 The specific conditions listed below may indicate the presence of control environment weaknesses. This section is designed to aid the auditor in considering each of the control environment factors described in paragraph 260.20 but is not intended to be all inclusive. The auditor should consider any other factors and conditions considered relevant.

.02 **MANAGEMENT'S PHILOSOPHY AND OPERATING STYLE**

- Management lacks concern about internal controls and the environment in which specific controls function.
- Management demonstrates an aggressive approach to risk taking.
- Management demonstrates an aggressive approach to accounting policies.
- Management has a history of completing significant or unusual transactions near the year's end, including transactions with related parties.
- Management is reluctant to (1) consult auditors/consultants on accounting issues, (2) adjust the financial statements for misstatements, or (3) make appropriate disclosures.
- Top-level management lacks the financial experience/background necessary for the positions held.
- Management is slow to respond to crisis situations in both operating and financial areas.
- Management uses unreliable and inaccurate information to make business decisions.
- Unexpected reorganization or replacement of management staff or consultants occurs frequently.
- Management personnel have a high turnover.

- Individual members of top management are unusually closely identified with specific major projects.

- Overly optimistic information on performance of programs and activities is disclosed.

- Financial estimates consistently prove to be significantly overstated or understated.

- Obtaining adequate audit evidence is difficult due to a lack of documentation and evasive or unreasonable responses to inquiries.

- Financial arrangements/transactions are unduly complex.

.03 **THE ENTITY'S ORGANIZATIONAL STRUCTURE**

- 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).

- The structure inhibits segregation of duties for initiating transactions, recording transactions, and maintaining custody over assets.

- Recent changes in the management structure disrupt the organization.

- Operational responsibilities do not coincide with the divisional structure.

- Delegation of responsibility and authority is inappropriate.

- A lack of definition and understanding of delegated authority and responsibility exists at all levels of the organization.
- Inexperienced and/or incompetent accounting personnel are responsible for transaction processing.
- The number of supervisors is inadequate or supervisors are inaccessible.
- Key financial staff have excessive work loads.
- Policies and procedures are established at inappropriate levels.
- The system for communicating policies and procedures is ineffective.
- A high degree of manual activity is required in capturing, processing, and summarizing data.
- Activities are dominated and controlled by a single person or a small group.
- The potential exists for entity officials to obtain financial or other benefits on the basis of decisions made or actions taken in an official capacity.

.04 **METHODS OF ASSIGNING AUTHORITY AND RESPONSIBILITY**

- The entity's policies are inadequate regarding the assignment of responsibility and the delegation of authority for such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- Employee job descriptions do not adequately delineate specific duties, responsibilities, reporting relationships, and constraints.

.05 **MANAGEMENT'S CONTROL METHODS FOR MONITORING AND FOLLOWING UP ON PERFORMANCE**

- Management is not sufficiently involved in reviewing the entity's performance.

- Management control methods are inadequate to investigate unusual or exceptional situations and to take appropriate and timely corrective action.

- Management lacks concern for and does not effectively, establish and monitor policies for developing and modifying accounting systems and control techniques.

- 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.

.06 **THE EFFECTIVENESS OF THE IG AND INTERNAL AUDIT**

- The audit staff are responsible for making operating decisions or for controlling other original accounting work subject to audit.

- Management personnel are inexperienced for the tasks assigned.

- Training activities are minimal, including little or no participation in formal courses and seminars and inadequate on-the-job training.

- Resources to effectively conduct audits and investigations inadequate.

- Audits are not focused on areas of highest exposure to the entity.

- Standards against which the auditor's work is measured are minimal or nonexistent.

- Performance reviews are nonexistent or irregular.

- 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.

- Supervision and review procedures are nonexistent or inadequate, including little involvement in the planning process, in monitoring progress, and in reviewing conclusions and reports.

- Workpaper documentation (audit programs, evidence of work performed, and support for audit findings) is incomplete.

- An inadequate mechanism is used to keep the entity head and the Congress informed about problems, deficiencies, and the progress of corrective action.

.07 **PERSONNEL POLICIES AND PRACTICES**

- Personnel policies for hiring and retaining capable people are inadequate.
- Standards and procedures for hiring, promoting, transferring, retiring, and terminating personnel are insufficient.
- Training programs do not adequately offer employees the opportunity to improve their performance or encourage their advancement.
- Written job descriptions and reference manuals are inadequately maintained.
- Communication of personnel policies and procedures at field locations is inadequate.
- The channels of communication for personnel reporting suspected improprieties are inappropriate.
- Policies on employee supervision are inappropriate or obsolete.

.08 **INFLUENCES EXTERNAL TO THE ENTITY**

- Estimates are sensitive to economic conditions affecting the entity or related entities.
- The President, the Congress, OMB, or the Secretary has exhibited special interest in the entity or one of its programs.
- The media has exhibited special interest in the entity or one of its programs.
- Management's follow-up action in response to communications from legislative or regulatory bodies is untimely and inappropriate.

.09 **MANAGEMENT'S CONTROL METHODS OVER BUDGET FORMULATION AND EXECUTION**

- Little or no guidance material and instructions are available to provide direction to those preparing the budget information.
- The budget review, approval, and revision process is not defined or understood.
- Management demonstrates little concern for reliable budget information.
- Management participation in directing, and reviewing the budget process is inadequate or limited.
- Management is not involved in determining when, how much, and for what purpose expenditures can be made.
- The planning and reporting systems that set forth management's plans and the results of actual performance are inadequate or insufficient .
- Inadequate methods are used to identify the status of actual performance and exceptions from planned performance and communicate them to the appropriate levels of management.
- Noncompliance with Antideficiency Act, purpose, time, or other budget-related restrictions has been previously reported.

.10 **MANAGEMENT'S CONTROL METHODS OVER COMPLIANCE WITH LAWS AND REGULATIONS**

- Management is unaware of the applicable laws and regulations and potential problems.
- A mechanism to inform management of the existence of illegal acts does not exist.
- Management neglects to react to identified instances of noncompliance with laws and regulations.
- Management is reluctant to discuss its approach toward compliance and the reasonableness of that approach.

- Recurring public complaints have been received through "hotline" allegations.

- Repeated instances of noncompliance or control weaknesses are disclosed in FMFIA reports; congressional reports; consultant's reports; and prior audits/evaluations by GAO, the IG, internal audit, or others.

- Management is reluctant to provide evidential matter necessary to evaluate whether noncompliance with laws and regulations has occurred.

- Management is not responsive to changes in legislative or regulatory bodies' requirements.

- Policies and procedures for complying with laws and regulations are weak or nonexistent.

- Policies on such matters as acceptable business practices, conflicts of interest, and codes of conduct are weak or nonexistent.

.11 **MANAGEMENT'S ABILITY TO PROMPTLY IDENTIFY AND REACT TO CHANGING CONDITIONS**

- The mechanisms for identifying and communicating events, activities, and conditions that affect operations or financial reporting objectives are insufficient.

- Accounting and/or information systems are not modified in response to changing conditions.

- No consideration is given to designing new or alternative controls in response to changing conditions.

- Management is unresponsive to changing conditions.

.12 **THE FUNCTIONING OF OVERSIGHT BODIES (INCLUDING CONGRESSIONAL COMMITTEES)**

- Oversight bodies demonstrate little concern toward controls and the speed with which internal and external auditors' recommendations are addressed.

- Oversight bodies have little involvement in and scrutiny of activities.

- Little interaction occurs between oversight bodies and the IG and internal and external auditors.

- Oversight bodies demonstrate little concern for compliance with applicable laws, regulations, and contractual requirements.

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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. Other methods of selecting locations for on-site testing may be used with the approval of the Director of Planning and Reporting or designee.

STRATIFYING THE LOCATIONS

.02 Unless a dollar-unit sampling method is used, which automatically stratifies the population, the auditor stratifies the locations by separating them into an appropriate number of relatively homogeneous groups or strata. The stratification should be based on relative size and/or qualitative factors, such as inherent or control risk. If exact information is not available, estimates may be used. Criteria for stratifying may include one or more of the following relative factors:

- the amount of assets;
- the amounts of revenue and expenses incurred or processed at the location;
- the number of personnel, where payroll costs are significant;
- the 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 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 total amount of assets is determined to be the relevant criterion for stratifying locations, the first three columns of table 295 C.1 may represent an acceptable stratification.

.04 **SELECTING LOCATIONS**

The auditor selects locations for on-site testing using one of the following methods for each stratum: (These methods are described in more detail in section 480.)

- Dollar-unit sampling (DUS) is used when sufficient quantitative data are available for sample selection. DUS should result in the smallest total sample sizes.

- DUS-approximation sampling is used when only a broad estimate of quantitative data is available for sample selection

- Another representative sampling method may be used when appropriate. The auditor should consult with the Director of Planning and Reporting or designee if another representative sampling method is used.

- Nonrepresentative selection is used when the auditor determines that it is appropriate and cost effective to select locations on a nonrepresentative basis and to apply substantive analytical procedures and/or other substantive tests to all locations that are not tested on-site.

.05 Table 295 C.1 illustrates a possible DUS-approximation sample for each stratum, using design materiality of $3 million and 95 percent assurance. For a DUS 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); accordingly, for a DUS-approximation sample, the preliminary estimate of the sample size is 125 (125 percent of the corresponding DUS sample size), and the implicit sampling interval is $800,000 ($100 million divided by 125 sample items). For DUS-approximation sampling, the auditor would select 42 locations for on-site testing (5 top stratum, 36 intermediate stratum, and 1 bottom stratum). Section 400 provides additional information on calculating the amounts in the table and the various selection methods.

TABLE 295 C.1: EXAMPLE OF DUS-APPROXIMATION SAMPLING

Stratum	Number of locations	Assets	Preliminary estimate of sample size[a]	Actual number of locations tested[b]
Top	5	$ 70,000,000	88	5
Inter-mediate	85	29,000,000	36	36
Bottom	10	1,000,000	1	1
Total	**100**	**$100,000,000**	**125**	**42**

[a] The preliminary estimate of sample size is computed by dividing the total balance by the implicit sampling interval of $800,000. Refer to section 400 for additional information concerning sampling.

[b] 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 $800,000, a $1.6 million selection would include two of the 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 should determine the total number of items to be tested, based on the applicable selection method and population, test materiality, and risk factors.

.07 The auditor should perform analytical and other procedures, as applicable, for both the locations selected and those not selected. Generally, the auditor should perform supplemental analytical procedures, including comparisons of locations with each other and with other years' information, for all locations, regardless of the selection method. When nonrepresentative selection is used, the auditor must apply appropriate substantive analytical procedures and/or other substantive procedures for locations not tested on-site, unless those locations are immaterial in total. Section 400 provides guidance on substantive and supplemental analytical procedures. Specific matters noted during the audit — for example, cutoff errors at one or more locations — may warrant increased audit procedures at locations not previously selected for on-site testing.

.08 In evaluating the result of a representative sample, the auditor estimates the effects, both quantitative and qualitative, on the entity as a whole of any misstatements noted. In doing so, the auditor should exercise considerable judgment and should apply the following procedures:

a. Determine if apparent misstatements are, in fact, misstatements that have not been corrected at some level in the entity.

b. Identify the cause of the misstatement.

c. If the evidence is highly persuasive that the misstatement is isolated to the location, obtain evidence that the same or similar type of misstatement does not exist at other locations (including locations not tested on-site). If the misstatement is isolated to the location, the effect on the entity is the same as that on the location.

d. If the misstatement is not isolated to the location, determine whether there is evidence that the misstatement exists in other than a similar proportion throughout the entity. If such evidence exists, the auditor should obtain evidence of the incidence rate and should determine the effect on the entity; additional testing may be required. If no such evidence exists, the auditor should project the misstatement to the entity.

.09 In a nonrepresentative selection, the auditor should consider the possible effects of misstatements on locations not visited and determine whether additional audit procedures are required. Because the selection is not representative, the misstatements can not be projected to the entity as a whole.

.10 The auditor should evaluate the sufficiency of audit procedures applied. The auditor should use judgment and should consider all relevant factors to determine whether the audit objectives are met, considering the specific circumstances.

295 D - INTERIM TESTING

.01 The auditor may consider performing significant substantive tests of balance sheet line items/accounts as of a date before the balance sheet date. If such interim tests are performed, the auditor should also apply audit procedures to the transactions during the "rollforward period" between the interim testing date and the balance sheet date (year end).

.02 Because evidence obtained as of the year end about an asset or liability balance provides a higher level of assurance than that obtained as of a prior or subsequent date, the audit risk generally increases as the length of the rollforward period increases. Although generally accepted auditing standards do not require moderate or low control risk to use interim testing, the auditor should consider inherent and control risk in determining whether substantive tests of the rollforward period can be designed to provide a reasonable basis for extending the audit conclusions from the interim testing date to the year end.

.03 The additional audit procedures that should be performed during the rollforward period ordinarily increase the overall audit costs. However, by performing these procedures before the year's end, the auditor may be able to

- more quickly identify and address significant audit and accounting issues, such as problem areas and complex or unusual transactions, enabling the entity to correct misstatements or the auditor to modify the audit plan;

- 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 Generally, the auditor should not perform interim tests for an assertion with a high control or combined risk. In such instances, all substantive testing of balance sheet line items/accounts generally should be performed as of the year end. If the preliminary assessment of control and combined risk is moderate or low and exceptions are noted in the tests of controls, the auditor should use judgment, considering the nature, cause, and estimated

effects of the exceptions, to determine whether revisions of the preliminary control and combined risk assessments and audit plan are warranted.

.05 In determining whether to apply interim testing, the auditor should consider the following factors:

- **The assessment of inherent and control risk:** The auditor should consider the risk of misstatement during the rollforward period, as well as all other relevant factors, including business conditions, that may make management more susceptible to pressures, causing a misstatement of the financial statements. As combined risk (inherent and control risk) increases, so does the extent of the additional procedures that should be applied to the rollforward period, possibly making interim testing much more costly than testing the year end balance. However, the auditor may be able to apply interim testing to certain assertions for which combined risk is assessed at lower levels while testing the other assertions as of the year end.

- **The anticipated comparability of the internal controls and the nature of the line item/account balances between the interim testing date and the year end:** To extend the audit conclusions from the interim date to the year end date, it is essential that no significant changes in the internal controls occur between those dates and that the line item/account balances consist of similar types of items at both dates.

- **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 amount of 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 expected to be lower.

- **The length of the rollforward period:** The longer the rollforward period, the more difficult it is to control the increased audit risk. The rollforward period generally should not be longer than 3 months.

- **The anticipated level of transaction activity during the rollforward period:** Interim testing generally decreases in effectiveness and efficiency as the level of transaction activity during the rollforward period increases, particularly if there are large or unusual transactions during this period.

- **The ease with which substantive procedures can be applied to test the transactions during the rollforward period:** As the difficulty of such procedures increases, the efficiency of interim testing generally decreases.

- **The availability of information to test rollforward period activity using substantive analytical procedures, detail tests, or a combination of both:** 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 the unavailability of necessary staff to perform audit procedures at the year's end may necessitate interim testing.

.06 In determining the timing of audit tests, the auditor should consider the relationships between line items/accounts that are affected by the same transactions. For example, if the auditor applies interim testing to inventory, the audit risk associated with inventory-related accounts payable, including cutoff matters, should be considered. The auditor may apply substantive procedures to each of the related line items/accounts as of the same interim testing date or may apply other procedures to obtain sufficient audit assurance.

.07 The auditor should document in the ARA line items/accounts (and assertions, where applicable) to which interim testing is applied. The factors considered when concluding that the use of interim testing is appropriate should be documented in the GRA.

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295 E - EFFECT OF RISK 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 assesses risk based on (but not limited to) knowledge of the entity, its business (purpose), applicable laws and regulations, and internal controls.

.02 The auditor considers both materiality and risk in (1) determining the nature, timing, and extent 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 inherent and control risk (combined risk), the higher the required level of substantive assurance from the audit procedures. The discussion of consideration of risk in planning begins at paragraph 260.02. Consideration of risk in determining sample size is discussed in section 470.

.03 As an example, assume that the auditor is testing accounts receivable using dollar-unit sampling techniques described in section 480. Following are the pertinent data for this test:

- Accounts receivable total $2.5 million.
- Test materiality is $100,000.

If the auditor assesses combined risk as low, the sample size would be 25 items; if assessed as high, the sample size would be 75 items. The increase in the assessment of risk caused the required sample size to triple with the same test materiality.

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295 F - TYPES OF EDP-RELATED CONTROLS

.01 As discussed in paragraph 270.04, the auditor should distinguish EDP-related controls. Such controls should be tested by an EDP audit specialist as described in section 300. EDP-related controls can be classified into three types:

- general controls,
- application controls, and
- user controls.

EDP GENERAL CONTROLS

.02 EDP general controls are the policies and procedures that apply to an entity's overall computer operations and that create the environment in which application controls and certain user control techniques operate. They are classified as

- organization and segregation of duties,
- systems design, development, and modification, and
- security.

Organization and Segregation of Duties

.03 Controls related to the organization of the EDP function typically address the following objectives:

- Computer operations should be adequately supervised and computer processing performed by authorized personnel.

- Segregation of duties within the EDP function should be appropriate.

- Management should appropriately follow up on recommendations made during internal and external reviews of EDP operations.

Systems Design, Development, and Modification

.04 Controls over the design, development, implementation, and modification of systems and applications programs are important to provide reasonable assurance that all development of and modifications to data and program logic are approved. In addition, effective systems design and

implementation helps to provide reasonable assurance that software brought on-line will adequately serve its intended purpose. Specific controls to address these issues are listed below:

- Systems software is modified and maintained in accordance with proper authorization, approval, and testing procedures.

- Formal and effective application systems development and maintenance methodologies are used.

- Users are an integral part of application development and maintenance procedures.

- Application systems are modified and maintained in accordance with proper authorization and approval procedures.

Security

.05 Security controls provide assurance that computer resources are protected against unauthorized physical and logical access and loss or impairment. Physical access to the computer system itself should be controlled by appropriate measures, such as locked facilities, with access allowed only to authorized individuals. General controls relating to logical access include the use of security access software (such as CICS, RACF, ACF2, or Top Secret in an IBM mainframe environment) and access controls programmed into applications. Security controls should also (1) protect the entity from the loss of computer resources due to theft, destruction, natural disaster, or other means and (2) limit the impact of such loss, if it should occur. For example, the entity should have appropriate backup, off-site storage, and routine contingency planning to provide reasonable assurance of continued processing in an emergency. Computer virus prevention software is also needed.

.06 General controls are established at an (1) entity and/or installation/system level and (2) application level. For example, consider the following general controls related to security access:

- In evaluating general controls at the entity or installation level, the EDP audit specialist considers security on an overall basis. For instance, the EDP audit specialist may evaluate the entity's use of security access software, including its proper implementation.

- When evaluating general controls at the application level, the EDP audit specialist reviews security controls that limit access to particular applications and related EDP files. Thus, the EDP audit specialist may focus on how security access software restricts access to payroll applications and related files (such as the employee master file and payroll transaction files) to authorized users.

- Finally, security is typically built into the application itself to further restrict authorized access. This security is usually accomplished by means of 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.

.07 The effectiveness of general controls is a significant factor in determining the effectiveness of application controls and certain user control techniques. Without effective general controls, application controls may be rendered ineffective by circumvention or modification. For example, the production 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. Certain user control techniques are also affected by general controls. For example, a user control procedure may be the comparison of manually calculated batch totals with computer-generated totals. Such a procedure would be ineffective if the general controls permitted unauthorized modifications of the program such that the program would print the desired batch totals without summarizing the detail.

EDP APPLICATION CONTROLS

.08 EDP application controls are incorporated directly into individual EDP applications to provide reasonable assurance of accurate and reliable processing. Application controls address three major operations:

- data input,
- data processing, and
- data output.

.09 As discussed in AU 319 (SAS 55), application controls consist of (1) programmed control techniques and (2) manual follow-up of EDP-produced exception reports (reports identifying rejected or unusual items).

Programmed control techniques are part of the computer processing function to provide reasonable assurance that the data are complete, accurate, and properly authorized. Examples of such techniques include

- determining that budgeted allotments are not exceeded when accepting a new obligation,
- comparing invoices to receiving reports and purchase orders, and
- making edit or validity checks to reject incomplete or unreasonable input or duplications.

.10 **Manual follow-up** of items identified by computer exception reports is critical to the effectiveness of EDP application controls. For example, the exception reports generated in the examples of programmed control techniques above should have a manual follow-up procedure to provide reasonable assurance that items identified in exception reports are properly recorded.

EDP USER CONTROLS

.11 User control techniques are manual comparisons of computer output (generally totals) to source documents or other input (including control totals). For example, a manual calculation of total hours worked may be reconciled to a corresponding computer-generated total from the payroll processing application. Where user control techniques are used, EDP-generated information should be manually compared with reliable information prepared or verified independently of the computer.

.12 In certain circumstances, user control techniques may function independently of general controls. For example, a user control procedure may be to manually check the accuracy and completeness of EDP-computed transactions against manually prepared records. With the concurrence of the EDP audit specialist, such techniques may be evaluated and tested without testing EDP general controls.

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 considered to be part of the internal controls covered in OMB Bulletin 93-06. During planning, the auditor should assess related inherent risk and the control environment and should obtain an understanding of the budget accounting system.

.02 Certain controls may achieve both financial reporting and other control objectives. Accordingly, to maximize efficiency, the auditor should coordinate the evaluation of budget controls with that of financial reporting, compliance, and operations controls, to the extent possible.

.03 Budget authority is "authority provided by law to enter into obligations which will result in immediate or future outlays involving government funds or to collect offsetting receipts" (2 U.S.C. 622(2)). The Congress provides an entity with budget authority and may place restrictions on the amount, purpose, and timing of the obligation or expenditure of such budget authority.

.04 The three forms of budget authority follow:

- **Appropriations** are the most common form of budget authority. An appropriation is an authorization by an act of the Congress that permits federal agencies to incur obligations and to make payments out of the Treasury for specified purposes. Appropriations do not represent cash actually set aside in the Treasury for purposes specified in the appropriation acts. They represent limitations of amounts that agencies may obligate during the period specified in the appropriation acts.

- **Borrowing authority** is statutory authority that permits obligations to be incurred but requires that funds be borrowed to liquidate the obligations (title 7). Usually, the amount that may be borrowed and the purposes for which the borrowed funds are to be used are stipulated by the authorizing statute.

- **Contract authority** is statutory authority that permits obligations to be incurred before appropriations or in anticipation of receipts to be credited to a revolving fund or other account (offsetting collections). By definition, contract authority is unfunded and must subsequently be

funded by an appropriation to liquidate the obligations incurred under the contract authority or by the collection and use of receipts.

.05 Offsetting collections are collections of a business- or market-oriented nature and intragovernmental transactions. If, pursuant to law, they are deposited to receipts accounts and are available for obligation, they are considered budget authority and referred to as offsetting receipts. Contract authority and immediate availability of offsetting receipts for use are the usual forms of budget authority for revolving funds. Offsetting collections may also include reimbursements for materials or services provided to other government entities.

.06 Borrowing and contract authority are sometimes called "back door authority," which refers to any type of budget authority that is provided by legislation outside the normal appropriations process.

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295 H - LAWS IDENTIFIED IN OMB BULLETIN 93-06

.01 When identifying significant provisions of laws and regulations (see paragraph 245.02), the auditor should consider the following laws and regulations[1] identified in OMB Bulletin 93-06 (see section 802 (Part II), General Compliance Checklist, and the referenced section for each law for internal control and compliance testing):

- Antideficiency Act, ch. 510 3, 34 Stat. 49 (codified as amended in 31 U.S.C. §§1341, 1342, 1349-1351, 1511-1519 (1988)) (section 803)

- Budget and Accounting Procedures Act of 1950, ch. 946, 64 Stat. 832 (codified as amended in various sections of 31 U.S.C.) (section 805)

- Chief Financial Officers Act of 1990, Pub. L. No. 101-576, 104 Stat. 2838 (codified in various sections of 5 U.S.C., 31 U.S.C., 38 U.S.C., 42 U.S.C.) (section 806)

- Civil Service Reform Act of 1978, Pub. L. No. 95-454, 92 Stat. 1111 (codified in various sections of 5 U.S.C., 10 U.S.C., 15 U.S.C., 28 U.S.C., 38 U.S.C., 39 U.S.C., 42 U.S.C.) (section 812)

- Civil Service Retirement Act of 1930, ch. 34 1-18, 46 Stat. 468, as renumbered July 31, 1956, ch. 804, title IV, §401, 70 Stat. 743 (codified as amended in 5 U.S.C. §1308, 3323, 8331-8348 (1988)) (section 813)

- Debt Collection Act of 1982, Pub. L. No. 97-365, 96 Stat. 1749 (codified in various sections of 5 U.S.C., 18 U.S.C., 26 U.S.C., 28 U.S.C., 31 U.S.C.) (section 809)

- Fair Labor Standards Act of 1938, ch. 676, 52 Stat. 1060 (codified as amended in 29 U.S.C. §§201-219 (1988)) (section 812)

- Federal Credit Reform Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388-610 (codified in various sections of 2 U.S.C.) (section 808)

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[1] The Federal Debt Collection Procedures Act of 1990 was listed in error by OMB.

- Federal Employees' Compensation Act, ch. 458, 39 Stat. 742 (codified as amended in various sections of 5 U.S.C.) (section 816)

- Federal Employees' Group Life Insurance Act of 1980, Pub. L. No. 96-427, 94 Stat. 1831 (codified in various sections of 5 U.S.C.) (section 815)

- Federal Employees Health Benefits Act of 1959, Pub. L. No. 86-382, 73 Stat. 708 (codified as amended in various sections of 5 U.S.C.) (section 814)

- Federal Managers' Financial Integrity Act of 1982 Pub. L. No. 97-255, 96 Stat. 814, 31 U.S.C. §§1105, 1113, 3512 (1988) (section 807)

- National Defense Authorization Act for Fiscal Year 1991, Pub. L. No. 101-510, 104 Stat. 1485, 1675, 31 U.S.C. §§1551-1557 (section 804)

- Prompt Payment Act, Pub. L. No. 97-177, 96 Stat. 85, 31 U.S.C. §§3901-3906 (1988) (section 810)

- Single Audit Act of 1984, Pub. L. No. 98-502, 98 Stat. 2327, 31 U.S.C. §§7501-7507 (1988) (section 811)

SECTION 300

Internal Control Phase

Figure 300.1: Methodology Overview

Planning Phase	Section
· Understand the entity's operations	220
· Perform preliminary analytical procedures	225
· Determine planning, design, and test materiality	230
· Identify significant line items, accounts and assertions	235
· Identify significant cycles and accounting applications	240
· Identify significant provisions of laws and regulations	245
· Identify relevant budget restrictions	250
· Assess inherent risk and the control environment	260
· Determine likelihood of effective EDP-related controls	270
· Identify relevant operations controls to evaluate and test	275
· Plan other audit procedures	280
· Plan locations to visit	285

Internal Control Phase	Section
· Understand internal control systems	320
· Identify control objectives	330
· Identify and understand relevant control techniques	340
· Determine the nature, timing, and extent of control tests	350
· Perform nonsampling control tests	360
· Assess controls on a preliminary basis	370

Testing Phase	Section
· Consider the nature, timing, and extent of tests	420
· Design efficient tests	430
· Perform tests and evaluate results	440
·· Sampling control tests	450
·· Compliance tests	460
·· Substantive tests	470
··· Substantive analytical procedures	475
··· Substantive detail tests	480

Reporting Phase	Section
· Perform overall analytical procedures	520
· Determine adequacy of audit procedures and audit scope	530
· Evaluate misstatements	540
· Conclude other audit procedures:	550
·· Inquire of attorneys	
·· Consider subsequent events	
·· Obtain management representations	
·· Consider related party transactions	
· Determine conformity with the entity's accounting principles	560
· Determine compliance with GAO Financial Audit Manual	570
· Draft reports	580

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310 - OVERVIEW

.01 In the internal control phase, the auditor should obtain evidence about the effectiveness of internal controls to (1) form an opinion on management's assertion about the effectiveness of internal controls as of the end of the audit period and (2) assess control risk and the effectiveness of budget and compliance controls during the audit period. In addition, the auditor should gain an understanding of performance measures controls and assess the design of the controls and whether they have been placed in operation. Control risk is a factor in determining the nature, timing, and extent of substantive procedures for the testing phase. Control risk should be assessed separately for each significant financial statement assertion in each significant cycle/accounting application. The effectiveness of budget and compliance controls are a factor in determining the nature, timing, and extent of compliance testing in the testing phase. (See figure 300.1.) OMB Bulletin 93-06 requires the auditor to gain an understanding of the internal control structure over the existence, completeness, and valuation (see definition in paragraph 235.02) assertions related to data supporting performance measures reported in the overview of the CFO report and assess the design of the controls and whether they have been placed in operation. Although the bulletin does not require the auditor to test performance measure controls, he or she may decide to do so. OMB intends to expand the auditor's responsibilities in this area in the future.

.02 The entity's management is responsible for establishing and maintaining an internal control structure to provide reasonable assurance that management objectives will be met. In a financial statement audit, the auditor evaluates those internal controls designed to:

- Safeguard assets against loss from unauthorized acquisition, use, or disposition (safeguarding controls).

- Assure the execution of transactions in accordance with budget authority (budget controls) and with laws and regulations that could have a direct and material effect on the financial statements or that are listed in OMB Bulletin 93-06 and could have a material effect on the financial statements (compliance controls).

- Properly record, process, and summarize transactions to permit the preparation of reliable financial statements and to maintain accountability for assets (financial reporting controls).

.03 The auditor should determine whether such internal controls provide reasonable assurance that losses, noncompliance, or misstatements, material in relation to the principal statements, would be prevented or detected at the end of the period (to support the opinion on management's assertion about the effectiveness of internal controls) and during the period (to support the assessments of control risk and of the effectiveness of budget and compliance controls). Additionally, the auditor may test certain operations controls and should understand performance measures controls and assess the design of the controls and whether they have been placed in operation, as discussed in the planning phase (section 275).

.04 Internal controls over safeguarding of assets constitute a process, effected by an entity's governing body, management, and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements. As used in this manual, safeguarding controls relate to protecting assets from loss arising from misstatements in processing transactions and handling the related assets. Section 395 C includes a list of typical safeguarding controls. Safeguarding controls examined as part of a financial statement audit do not relate to the loss of assets arising from management's operating business decisions, such as incurring expenditures for equipment or material that might prove to be unnecessary. (Such controls are operations controls.) Safeguarding controls consist of (1) controls that prevent or detect unauthorized access (direct or indirect) to assets and (2) segregation of duties. In this manual, safeguarding controls are considered as part of financial reporting controls.

.05 The auditor must evaluate and test the following types of controls:[1]

- **financial reporting controls** for each significant assertion in each significant cycle/accounting application (identified in section 240),

[1] AU 319 (SAS 55) permits the auditor to assess control risk at a high (maximum) level and forgo evaluation and testing of financial reporting controls if the auditor believes evaluating their effectiveness would be inefficient. However, because OMB Bulletin 93-06 requires the auditor to determine whether the internal controls provide reasonable assurance of achieving the objectives described in paragraph 310.02 and are operating effectively, the auditor may not elect to forgo control tests solely because it is more efficient to extend compliance and substantive audit procedures.

- **budget controls** for each relevant budget restriction (identified in section 250),

- **compliance controls** for each significant provision of laws and regulations (identified in section 245), and

- **operations controls** for each operations control (1) relied on in performing financial audit procedures or (2) selected for testing by the audit team. The auditor should also understand performance measures controls and assess the design of the controls and whether they have been placed in operation, but does not need to test performance measures controls (according to OMB Bulletin 93-06), although the auditor may decide to test them (see section 275).

.06 In the internal control phase, the auditor should perform and document the following procedures:

- Understand the entity's internal control structure for financial accounting and budget accounting; compliance with laws and regulations; and relevant operations (including reported performance measures) (see section 320).

- Identify control objectives (see section 330).

- Identify and understand relevant control policies and procedures (control techniques) that effectively achieve the control objectives (see section 340).

- Determine the nature, timing, and extent of control testing (not necessary for performance measures controls) (see section 350).

- Perform control tests that do not involve sampling (nonsampling control tests - see section 360).[2] (Sampling control tests are performed in the testing phase, as discussed in section 450.) Testing is not required for performance measures controls.

[2] The auditor should consider coordinating sampling control tests with substantive audit procedures and/or tests of compliance with laws and regulations (multi-purpose tests) to maximize efficiency. See section 450 for further discussion.

- On a preliminary basis, based on the evidence obtained, assess (1) the effectiveness of financial reporting, budget, compliance, and relevant operations controls (for performance measures controls, assess the design of the controls and whether they have been placed in operation) and (2) control and combined risk (see section 370). (Combined risk, which includes inherent and control risk, is discussed in paragraph 370.09).

.07 In gaining an understanding of an entity's internal control structure, the auditor should obtain knowledge about the design of relevant policies, procedures, and records and whether they have been placed in operation. In obtaining knowledge about whether internal control structure policies, procedures, or records have been placed in operation, the auditor determines that the entity is using them, rather than merely having them written in a manual, for example. This differs from determining a policy, procedure, or record's operating effectiveness, which is concerned with how the policy, procedure, or record was applied, the consistency with which it was applied, and by whom. Gaining an understanding of the internal control structure does not require that the auditor obtain knowledge about operating effectiveness.

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320 - UNDERSTAND INTERNAL CONTROL SYSTEMS

.01 The auditor should obtain an understanding of the entity's systems (including methods and records) for processing and reporting accounting, budget, compliance, and operations data (including performance measures reported in the overview of the CFO report).[1] The auditor should obtain sufficient knowledge of each type of system to understand the information in paragraphs 320.02-.05. The auditor may use an EDP audit specialist to assist in understanding and documenting the EDP aspects of these systems. The understanding of the systems should be documented in cycle memorandums or other narratives and flow charts. The auditor should perform sufficient system walkthroughs to confirm the understanding of significant information about such systems. However, if the auditor already has a sufficient understanding of the systems as a result of procedures performed in the preceding year, discussion of any system changes with management may be substituted for the walkthroughs. In a walkthrough 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 and examining related documents. Because walkthroughs are important in understanding the transaction process and in determining appropriate audit procedures, they should be performed for all significant accounting applications. Walkthroughs of budget accounting, compliance, and operations systems (including reported performance measures) should provide the auditor with evidence about the functioning of such systems. The EDP aspects of each system should be incorporated into the audit workpapers, supplemented by additional flow charts, narratives, and checklists, as considered necessary.

[1] As indicated in paragraphs 260.25-.26, the FMFIA report and its supporting documentation may be considered as a starting point for evaluating internal controls. The auditor may use management's documentation of systems and internal controls where appropriate. Management's tests of controls may be used by the auditor in testing controls, if such tests were executed by competent individuals independent of the controls. (See AU 322 (SAS 65) for further information.)

ACCOUNTING SYSTEM(S)

.02 The auditor should obtain an understanding of and should document the following for each significant cycle and accounting application:

- the manner in which transactions are initiated;
- the nature and type of records, journals, ledgers, and source documents, and the accounts involved;
- the 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; and
- the process used to prepare the entity's financial statement and budget information, including significant accounting estimates, disclosures, and computerized processing.

BUDGET ACCOUNTING SYSTEM(S)

.03 Through discussions with individuals responsible for accounting for budget execution, the auditor should understand and document the entity's process for:

- Developing and requesting apportionments from the OMB;
- Establishing and allocating allotments within the entity, including reprogramming of allotments;
- Establishing and recording commitments, if applicable;
- Establishing and recording obligations (undelivered orders);
- Establishing and recording expenditures (delivered orders);
- Monitoring supplemental appropriations;
- Recording transactions in and adjustments to expired accounts; and
- Monitoring closed accounts.

COMPLIANCE SYSTEM(S)

.04 The compliance system includes the entity's policies and procedures to monitor overall compliance with laws and regulations applicable to the entity. Through discussions with entity management, the auditor should understand and document the entity's process for:

- Identifying and documenting all laws and regulations applicable to the entity;

- Monitoring changes in applicable laws and regulations and responding on a timely basis;
- Establishing policies and procedures for complying with specific laws and regulations and clearly documenting and communicating these policies and procedures to appropriate personnel;
- Assuring that an appropriate number of competent individuals at appropriate levels within the entity monitor the entity's compliance with applicable laws and regulations; and
- Investigating, resolving, communicating, and reporting any noncompliance with laws and regulations.

OPERATIONS SYSTEM(S) (INCLUDING REPORTED PERFORMANCE MEASURES)

.05 Through discussions with appropriate entity personnel, the auditor should understand and document any entity systems in which operations controls to be evaluated and tested operate, and any systems which produce the data used in performance measures reported in the overview of the CFO report. For example, if the auditor intends to evaluate and test an operations control that is dependent on certain statistical information, the auditor should understand how such statistical information is developed. Also, although the auditor is not required to test controls over a system producing data used in performance measures (unless it is an accounting or other system tested for other reasons), he or she should understand the system and the internal controls related to the existence, completeness, and valuation (see definition in paragraph 235.02) assertions and assess the design of the controls and whether they have been placed in operation. Thus, the auditor should understand and document the following:

- how the entity determines the performance measures to report, including their relationship to the entity's mission;
- the source of the information used in performance measures;
- the processing involved from the initial source information to its inclusion in performance measures, including the nature of computer files and the manner in which they are accessed, updated, and deleted; and
- the process used to prepare the performance measures from the system-produced data.

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330 - IDENTIFY CONTROL OBJECTIVES

.01 The auditor should identify control objectives for each type of control that, if achieved, would provide the entity with reasonable assurance that losses, noncompliance or misstatements material in relation to the principal statements would be prevented or detected. Such objectives should cover the following general areas:

- **Financial reporting controls:** Prevent or detect aggregate misstatements in significant financial statement assertions.

- **Budget controls:** Execute transactions in accordance with budget authority.

- **Compliance controls:** Comply with significant provisions of applicable laws and regulations.

- **Operations controls:** For each relevant operations control, improve the planning, productivity, quality, economy, efficiency, or effectiveness of the entity's operations. For performance measures controls, report reliably and completely the data used to measure the entity's performance.

Paragraphs 330.02-.11 describe the process for identifying control objectives for each type of control.

FINANCIAL REPORTING CONTROLS

.02 The auditor should evaluate and test financial reporting controls for each significant assertion in each significant line item or account. (See paragraph 235.02 for a discussion of financial statement assertions.) The first step in developing 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 the following four areas:

- **Validity:** Recorded transactions do not represent economic events that actually occurred.

- **Cutoff:** Transactions are recorded in a different period from that in which the economic events occurred.

- **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, there are one or more control objectives that, if achieved, would prevent or detect the potential misstatement. These potential misstatements and control objectives provide the auditor the primary basis for assessing the effectiveness of an entity's control techniques.

Identifying Potential Misstatements and Control Objectives

.03 As discussed in section 240, the auditor identifies the significant accounting applications that provide a source of significant entries to each significant line item or account. For example, as illustrated in section 395 A, (1) sources of significant entries to cash typically include the cash receipts, cash disbursements, payroll, and cash accounting applications, and (2) sources of significant entries to accounts receivable typically include the billing, cash receipts, and accounts receivable accounting applications. Such accounting applications should have been identified in the cycle matrix or ARA.

.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 The following general rules may be used to determine the effect of transaction related accounting applications on line items/accounts:

Transaction-Related Accounting Application Assertion	Affected Line Item/Account Assertion
Existence or Occurrence	· Existence or occurrence, if the application increases the line item/account balance · Completeness, if the application decreases the line item account balance
Completeness	· Completeness, if the application increases the line item/account balance · Existence or occurrence, if the application decreases the line item/account balance
Valuation	· Valuation

.06 For each potential misstatement in the accounting application, the auditor should identify related control objectives that prevent or detect the potential misstatement. Section 395 B includes a list of potential misstatements that could occur in each assertion in an accounting application and related control objectives. The auditor should exercise judgment in determining which potential misstatements and control objectives to use. The list included in section 395 B should be tailored to the accounting application and to the entity and may be supplemented with additional objectives or subobjectives.

.07 If the above procedures were performed and documented by line item or account, a given application might be addressed two or more times. For example (see section 395 A), the purchasing accounting application typically would be addressed in evaluating controls relating to the inventory, property, liabilities, and expenses accounts. To avoid such duplication, the auditor should use a Specific Control Evaluation (SCE) worksheet to document the procedures discussed in paragraphs 330.03-.06. The SCE groups potential misstatements and control objectives by accounting

application (within each cycle), providing a format to perform and document the evaluation and testing of internal controls efficiently. See section 395 H for an example of a completed SCE worksheet. AIMD has developed a computer system for preparing the ARA and SCE worksheets, which is available from the Micropomputer Support Group, as are WordPerfect 5.1 templates.

The Need for Testing Safeguarding Controls, Including Segregation of Duties

.08 Safeguarding controls, including segregation-of-duties controls, are often critical to the effectiveness of controls over liquid (easily sold or traded), readily marketable assets (such as cash, inventories, or property) that are highly susceptible to theft, loss, or misappropriation in material amounts. Before selecting specific control techniques to test, the auditor should determine whether safeguarding controls are relevant. If the auditor determines that (1) the asset is highly liquid or marketable and (2) material amounts are susceptible to theft, loss, or misappropriation, the auditor should identify control objectives for safeguarding such assets and evaluate and test safeguarding controls. On the other hand, if the asset is not liquid or marketable or if material amounts are not readily susceptible to theft, loss, or misappropriation, the need to test safeguarding controls may be lessened. (Testing for segregation of duties is discussed in paragraphs 360.11-.12. Other safeguarding controls are considered in connection with financial reporting controls, as part of the existence assertion.)

BUDGET CONTROLS

.09 The overall objective of budget controls is to provide reasonable assurance that the entity executes transactions in accordance with budget authority. Section 395 F presents a list of budget control objectives, organized by steps in the budget execution process. In addition, section 395 D presents a list of selected statutes relevant to budget execution and section 395 E describes budget execution steps of interest to the auditor in evaluating an entity's budget controls. Budget control objectives may be documented in a separate SCE worksheet for budget controls, in a memo, or incorporated in an SCE with financial reporting controls, if budget and accounting systems are integrated.

COMPLIANCE CONTROLS

.10 The objective of compliance controls is to provide reasonable assurance that the entity complies with significant provisions of applicable laws and regulations. Compliance control objectives should be tailored to the related provision and may be documented in a separate SCE worksheet for compliance controls, in a memo, or incorporated into an SCE 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 goals. The objective of performance measures controls is to provide reasonable assurance that the data that support performance measures reported in the overview of the CFO report are properly recorded and accounted for to permit the preparation of reliable and complete performance information. Operations control objectives should be tailored to the related provision and may be documented in a separate SCE worksheet for operations controls, in a memo, or incorporated into an SCE with related financial reporting controls.

340 - IDENTIFY AND UNDERSTAND RELEVANT CONTROL TECHNIQUES

.01 For each control objective, based on discussions with entity personnel, the auditor should identify the control techniques designed and implemented to achieve the specific control objective.[1] Such controls may be recorded in the auditor's informal notes and/or interview write-ups for use in the following procedure, but each control technique need not be formally documented on the SCE worksheet at this time. The auditor should first screen the techniques to identify those that are effective and efficient to test. An EDP audit specialist may assist the auditor in identifying and understanding EDP-related controls.

BASIC UNDERSTANDING OF EFFECTIVENESS OF CONTROL TECHNIQUES

.02 The auditor should obtain a sufficient understanding of the identified control techniques to determine whether they are likely to achieve the control objectives, assuming a good control environment, appropriate segregation of duties, and good EDP general controls. The purpose of this assumption is to identify any weaknesses in the specific control techniques that should be corrected. When a poor control environment, inadequate segregation of duties, or poor EDP general controls preclude the effectiveness of specific control techniques that would otherwise be effective, the testing of such specific control techniques should be limited to determining whether such controls are in place. To accomplish this, the auditor might (1) discuss the cycle and specific controls with management and then (2) perform walkthroughs by observing the controls in place or examining several items of documentary evidence of their existence.

FACTORS TO CONSIDER

.03 When evaluating whether controls are likely to achieve the control objectives, the factors that the auditor should consider include (1) directness, (2) selectivity, (3) manner of application, and (4) follow-up. In determining whether control objectives are achieved, the auditor should

[1] Section 395 C presents a list of typical control techniques that an entity may establish to help prevent or detect misstatements in financial statement assertions.

consider both manual and EDP-related controls, if likely to be effective (see section 270).

.04 **Directness** refers to the extent that a control technique relates to a control objective. The more direct the relationship, the more effective that technique 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 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 consider 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 laws and regulations, or significant ineffective or inefficient use of resources. The auditor also should consider the appropriateness of the specified criteria used to identify items on a management or exception report. For example, EDP 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. The auditor should consider the following factors when determining the effectiveness of controls:

- **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.

- **Experience and skills of personnel:** This refers to whether the person applying a control has the necessary knowledge and expertise to properly apply it. The lesser the person's experience and skills, the 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 followed when a control identifies an exception condition. A control's effectiveness is dependent on the effectiveness of follow-up procedures. To be effective, these procedures should be applied on a timely basis and should (1) determine whether control exceptions represent misstatements and (2) 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 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 consider whether the controls also are applied effectively to adjustments/corrections made to the financial records. Such adjustments/corrections may occur at the transaction level, during summarization of the transactions, or may be posted directly to the general ledger accounts.

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350 - DETERMINE THE NATURE, TIMING, AND EXTENT OF CONTROL TESTS

.01 For each control objective, the auditor should (1) identify specific relevant control techniques to test (see paragraphs 350.02-.04), (2) perform walkthroughs to be sure that those controls are in operation (see paragraph 350.05), (3) document these control techniques on the SCE worksheet (see paragraph 350.06), (4) determine the nature and timing of control tests (see paragraphs 350.07-.14), and (5) determine the extent of control tests (see paragraphs 350.15-.16). For the controls over performance measures reported in the overview of the CFO report, the auditor does not need to test controls (although he or she may decide to do so), but should identify the techniques likely to achieve the objectives, perform walkthroughs to be satisfied they have been placed in operation, and document the controls.

IDENTIFY RELEVANT CONTROLS TO TEST

.02 For each control objective identified in Section 330, the auditor should identify the control technique, or combination of control techniques, that is likely to (1) achieve the control objective and (2) maximize the overall efficiency of control tests. In doing this, the auditor should consider (1) the extent of any inherent risk[1] and control environment weaknesses,[2] including those related to EDP (as documented in the ARA and/or GRA document (see section 260)) and (2) the tentative determination of the likelihood that EDP-related controls will be effective, as determined in the planning phase (see section 270). The auditor should test only the control techniques 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 should select and test the control technique that is most efficient to test, considering such factors as (1) the extent to which a control achieves several control objectives and thereby reduces the number

[1] Assertions that have high inherent risk normally require stronger or more extensive controls to prevent or detect misstatements than assertions without such risk.

[2] Control environment weaknesses may result in ineffective control techniques. If so, the auditor should still identify and test specific control techniques, but the extent of such testing should be limited, as discussed in paragraph 340.02.

of controls that would ordinarily need to be tested, and (2) the time that will be required to test the control.

.03 For those control objectives for which the auditor preliminarily determines that effective control techniques exist or are likely to exist, the auditor should test the selected control techniques, as discussed in sections 360 and 450. The auditor may test all, or only certain control techniques (because others are not likely to be effective), related to a control objective. However, the auditor may 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 control techniques selected for testing are, in fact, ineffective in design or operation, the auditor should discontinue the specific control evaluation of related control objectives and should report resulting weaknesses in internal controls as discussed in section 580. If the entity's management does not agree with the auditor's conclusion that effective control techniques do not exist or are unlikely to exist, the auditor may need to perform procedures sufficient to support that conclusion.

.04 Before testing controls the auditor believes will be effective, the auditor may elect to complete the ARA tentatively, assuming that such controls are effective.

PERFORM WALKTHROUGHS TO ASSURE THAT THOSE CONTROLS ARE IN OPERATION

.05 Before performing control tests, the auditor should perform one or more walkthroughs to assure that the control techniques are functioning in the manner understood by the auditor. These walkthroughs, designed to confirm the auditor's understanding of the control techniques, differ from those performed to confirm the auditor's understanding of the systems in which they operate (see paragraph 320.01). Through observations, inspection, and discussions with personnel responsible for applying or maintaining each control (including walkthroughs), the auditor should determine whether each control has, in fact, been placed in operation. If a control has not been placed in operation, the auditor should consider whether other controls are likely to achieve the related control objective(s) and should consider testing such controls.

DOCUMENT CONTROLS TO BE TESTED

.06 The auditor should document the controls to be tested on the SCE worksheet. (See an illustration in section 395 H.) Controls that satisfy more than one control objective may be listed (and evaluated) only once and referred to, when applicable, on subsequent occasions. For each control to be tested, the auditor should determine whether the control is EDP-related. An EDP audit specialist generally should review and concur with the auditor's identification of such EDP-related controls.

DETERMINE THE NATURE AND TIMING OF CONTROL TESTS

.07 To obtain additional evidence of the effectiveness of specific controls, the auditor should select the combination of control tests (observation, inquiry, or inspection) to be performed and determine the timing of such tests. No one specific control test is always necessary, applicable, or equally effective in every circumstance. In fact, a combination of these types of control tests is usually needed to provide the necessary level of assurance. In determining the types of tests to apply, the auditor should select the tests that are effective and most efficient, as discussed in paragraphs 350.11-.14. Specific types of control tests and methods to apply them are discussed below.

.08 **Observation** - The auditor conducts observation tests by observing entity personnel actually performing control techniques in the normal course of their duties. Observation generally provides highly reliable evidence that a control technique 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, observation tests should be supplemented by corroborative evidence obtained from other tests (such as inquiry and inspection) as to the operation of controls at other times.

.09 **Inquiry** - The auditor conducts inquiry tests by making either oral or written inquiries of entity personnel involved in the application of specific control techniques to determine what they do or how they perform a specific control technique. Such inquiries are typically open ended. Generally, evidence obtained through inquiry is the least reliable audit evidence and generally should be corroborated through other types of control tests (observation or inspection). The reliability of evidence obtained from inquiry depends on various factors, such as 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.

- Whether the evidence was provided orally or in writing. Generally, evidence provided in writing is more reliable than evidence provided orally.

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.10 **Inspection** - The auditor conducts inspection tests by examining documents and records for evidence (such as the existence of initials, signatures, or other indications) that a control technique was applied to those documents and records. System documentation, such as operations manuals, flow charts, and job descriptions, may provide evidence of control design but do not provide evidence that controls are actually operating and being applied consistently. To use system documentation as part of the evidence of effective control techniques, 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 multi-purpose 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 walkthroughs (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, if the auditor needs additional evidence, sampling items for inspection should be considered. 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.

.11 The type of control test or tests the auditor selects depends on (1) the nature of the control to be tested and (2) the timing of and period covered by the control test.

.12 The **nature of the control** influences the type of evidential matter that is available. For example, if the control provides documentary evidence, the auditor may decide to inspect the documentation. For other controls, such documentation may not be available or relevant. For example, segregation-of-duties controls generally do not provide documentary evidence. In such circumstances, the auditor may obtain evidential matter about the effectiveness of operation through observation or inquiry.

.13 The **timing of and period covered by the control test** require consideration. The evidential matter should relate to the audit period and, unless it is documentary evidence, should be obtained 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. Paragraph 380.02 provides guidance concerning situations when new controls are implemented during the year.

.14 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 walkthroughs (tests of controls that do not involve sampling) provide sufficient evidence that the control was effective during the year and are most efficient to test. When sampling is considered necessary, the auditor should consider performing multi-purpose tests to enhance audit efficiency (see sections 430 and 450).

DETERMINE THE EXTENT OF NONSAMPLING CONTROL TESTS

.15 After selecting the nature of control tests to be performed, the auditor should determine the extent of control tests (including EDP controls). This determination is based on the information gathered in developing an understanding of the internal controls, the nature of the control to be tested, the nature and availability of evidential matter, and the auditor's determination of the amount of additional evidence needed. For each control technique considered necessary to achieve the control objectives, the

auditor should test such technique to determine whether it achieves 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 section 360 for nonsampling control tests and in section 450 for sampling control tests.

.16 Controls that do not leave documentary evidence of existence or application generally cannot be tested with sampling procedures. When control techniques, 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 evidential matter about the proper segregation of duties by (1) direct observation of the control techniques being applied at a specific time during the audit period and (2) inquiry of the individual(s) involved about applying the techniques 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 effectiveness (see section 370).

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360 - PERFORM NONSAMPLING CONTROL TESTS

.01 The auditor should design and conduct tests of control techniques that are effective in design to confirm their effectiveness in operation. (The auditor should refer to paragraph 380.02 if control techniques were not effective in design during the entire audit period.) The auditor should perform the following procedures in connection with control tests:

- Request an EDP audit specialist to test EDP-related controls.
- Perform nonsampling control tests. (Sampling control tests are performed in the testing phase, as discussed in section 450.)
- Evaluate the results of nonsampling control tests.

TESTS OF EDP-RELATED CONTROLS

.02 In an entity that uses EDP to perform accounting functions, the auditor might identify controls whose effectiveness depends on EDP (EDP-related controls). Such EDP-related controls are discussed in more detail in section 295 F. Due to the technical nature of certain EDP-related controls, an EDP audit specialist should perform or supervise tests of such controls and should document conclusions on the effectiveness of EDP-related controls during the audit period.

.03 If EDP-related controls are identified for testing, an EDP audit specialist should evaluate the effectiveness of:

- general controls at the entity or installation level;
- general controls as they relate to the application to be tested; and
- specific application controls and/or user control techniques, unless the EDP-related controls that achieve the control objectives are general controls.

.04 The EDP audit specialist should determine whether overall or installation level general controls are effectively designed and operating by:

- identifying applicable general controls,
- determining how those controls function, and
- evaluating and testing the effectiveness of those controls;

The EDP audit specialist should consider knowledge obtained in the planning phase. At the conclusion of this step, the EDP audit specialist should document the understanding of general controls and should conclude whether such controls are effectively designed and operating as intended.

Tests of General Controls at the Installation Level

.05 EDP general controls ordinarily are tested through a combination of procedures, including observation, inquiry, inspection (which includes a review of documentation on systems and procedures), and re-performance using appropriate test software. Sampling is generally not used to test EDP general controls.

.06 If general controls are not effectively designed and operating as intended, any programmed control techniques and certain user control techniques identified for testing generally will be ineffective. In such instances, (1) the EDP audit specialist should discuss the nature and extent of risks resulting from ineffective general controls with the audit team, and (2) the auditor should consider whether manual controls achieve the control objectives that the EDP-related controls were supposed to achieve. However, if manual controls do not achieve the control objectives, the EDP audit specialist should determine whether any specific EDP-related controls are designed to achieve the objectives. If not, the auditor should develop appropriate findings principally to provide recommendations to improve internal controls. If specific EDP-related controls are designed to achieve the objectives, but are in fact ineffective due to poor general controls, testing would typically not be necessary, except to support findings.

Tests of General Controls at the Application Level

.07 Based on favorable conclusions reached on general controls at the entity or installation level, the EDP audit specialist should evaluate and test the effectiveness of general controls for those applications within which application controls or user control techniques are to be tested.

.08 If general controls are not operating effectively within the application, application controls and user control techniques generally will be ineffective. In such instances, the EDP audit specialist should discuss the nature and extent of risks resulting from ineffective general controls with the audit team and should determine whether to proceed with the evaluation of application controls and user control techniques.

Tests of Application Controls and User Control Techniques

.09 The EDP audit specialist generally should perform or supervise tests of those application controls and user control techniques necessary to achieve the control objectives where the overall and application-level general controls were determined to be effective.

NONSAMPLING CONTROL TESTS

.10 The auditor should (1) develop a detailed control test audit program that incorporates the nature, timing, and extent of planned nonsampling control tests and (2) perform nonsampling control tests according to the audit program. The following paragraphs discuss the testing of segregation of duties.

Segregation of Duties

.11 Nonsampling control tests relating to segregation of duties requires special consideration. Such controls are designed to reduce the opportunities for any person to be in a position both to perpetrate and to conceal misstatements in the normal course of duties. Typically, an entity achieves adequate segregation of duties by establishing controls (such as segregating asset custody from record-keeping functions) to prevent any person from having uncontrolled access to both assets and related records. Paragraph 330.08 describes situations in which the auditor should test segregation of duties.

.12 The auditor may use the following method 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. Direct access exists when the individual is authorized to handle the assets directly (such as during the processing of cash receipts). Indirect access exists when the individual 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 EDP provides access to assets, evaluation and testing of EDP-related controls should be designed to identify (1) individuals (including EDP personnel) who may use EDP 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 made by that person. In an EDP-based 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 consider whether other controls would mitigate its effects.

EVALUATING THE RESULTS OF NONSAMPLING TESTS

.13 The auditor should investigate and understand the reasons for any deviations from control techniques 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 should conclude 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 one month due to personnel turnover. For all but that month, the auditor may assess controls as effective and reduce related testing. The auditor also should consider whether other controls can achieve the related control objective(s).

.14 Additionally, the auditor should gather sufficient evidence to report the control weakness. As discussed in paragraphs 580.46-.53, significance of the weakness will determine how the auditor reports the finding and therefore which elements of the finding (condition, cause, criteria, effect, and recommendation or suggestion) need to be developed.

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370 - ASSESS CONTROLS ON A PRELIMINARY BASIS

.01 Based on the evaluation of internal controls and results of nonsampling control tests, the auditor should preliminarily assess the effectiveness of internal controls as of the end of the period (for the auditor's opinion on management's assertion about the effectiveness of internal controls) and during the period (for determining the extent of procedures performed in the testing phase). Considerations for assessing the effectiveness of EDP-related controls and each type of control (financial reporting, budget, compliance, and operations) are discussed in paragraphs 370.06-.14 below.

.02 To assess the effectiveness of internal controls, the auditor considers whether the control objectives are achieved. For each control objective that is not fully achieved, the auditor should obtain sufficient (1) information to develop comments in the auditor's report or management letter (see paragraphs 580.31-.57) and (2) evidence to support the preliminary assessment of the effectiveness of internal controls.

EDP-RELATED RESULTS

.03 Based on the procedures performed, the EDP audit specialist should discuss conclusions on the effectiveness of EDP-related controls with the audit team and obtain concurrence. The auditor should (1) incorporate the EDP audit specialist's conclusions into the audit workpapers for each EDP-related control tested and (2) perform tests of application controls (principally manual follow-up of exceptions) or user control techniques identified by the EDP audit specialist for the audit team to test.

.04 If EDP-related controls are determined to be effective, the auditor may also use the EDP audit specialist to identify any EDP-related controls within the applications tested by the above procedures that were not previously identified by the auditor. For example, such EDP-related controls might achieve control objectives not otherwise achieved through manual controls or might be more efficient or effective to test than manual controls. The EDP audit specialist can assist the auditor in determining the cost effectiveness of searching for and testing additional EDP-related controls. Decisions made in response to these considerations should be documented, including a description of the expected scope of the EDP audit specialist's work.

| .05 Audit programs and supporting workpapers should be prepared to document the procedures for evaluating and testing the effectiveness of EDP-related controls. Such workpapers should be included in the audit workpapers.

FINANCIAL REPORTING CONTROLS

.06 Based on procedures performed and before sampling control tests[1], if any, the auditor should form a preliminary conclusion about (1) the effectiveness of financial reporting controls as of the end of the period and (2) the assessed level of control and combined risk during the period for each significant assertion in each significant line item or account. Combined risk is the risk that, prior to the application of substantive audit procedures, a material misstatement exists in a financial statement assertion. Combined risk consists of the risks that (1) a financial statement assertion is susceptible to material misstatement (inherent risk) and (2) such misstatement is not prevented or detected on a timely basis by the entity's internal controls (control risk). The use of professional judgment is essential in assessing both control and combined risk.

.07 **Preliminary assessment of control risk.** For <u>each significant assertion</u> in each significant account, the auditor should assess control risk at one of the following three levels:

- **Low control risk:** The auditor believes that controls <u>will</u> prevent or detect any aggregate misstatements that could occur in the assertion in excess of design materiality.

- **Moderate control risk:** The auditor believes that controls will <u>more likely than not</u> prevent or detect any aggregate misstatements that could occur in the assertion in excess of design materiality.

- **High control risk:** The auditor believes that controls will <u>more unlikely than likely</u> prevent or detect any aggregate misstatements that could occur in the assertion in excess of design materiality. Generally, the auditor will not be able to express an unqualified opinion on management's assertion about the effectiveness of related internal

[1] The auditor may assess control and combined risk on a preliminary basis at an earlier point in the audit, if preferred.

controls unless management recognizes the control weakness(es) in its assertion.

.08 In assessing control risk in a line item/account assertion, the auditor should consider the aggregate magnitude of misstatements that might not be prevented or detected 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 consider the risk that aggregate misstatements could arise from a combination of those accounting applications and not be prevented or detected by controls.

.09 **Preliminary assessment of combined risk.** In assessing combined risk, the auditor should consider 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 controls (control risk). This preliminary assessment of combined risk should be consistent with the auditor's assessment of inherent risk and control risk. For each significant assertion in each significant account, the auditor should assess combined risk at one of the following three levels:

- **Low combined risk:** 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 design materiality.

- **Moderate combined risk:** 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 design materiality.

- **High combined risk:** 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 design materiality. As a result, the auditor will need to obtain most, if not all, audit reliance from substantive tests.

.10 The minimum substantive assurance level required for substantive tests varies directly with combined risk. In other words, as combined risk increases, so does the minimum substantive assurance level. Section 470

discusses the assurance level. The auditor should document the preliminary assessment of control risk and combined risk in the ARA.

BUDGET CONTROLS

.11 Based on the evaluation and tests of budget controls and other audit procedures, the auditor must:

- conclude whether the entity's internal controls provide reasonable assurance that the entity executed transactions in accordance with budget authority as of the end of the period (to support the opinion on management's assertion about the effectiveness of internal controls) and, if necessary, during the period, to test compliance (as discussed in section 460), and

- report weaknesses in budget controls that come to the auditor's attention (see paragraphs 580.31-.57).

.12 When forming these conclusions on the internal controls related to budget execution, the auditor should consider the impact of any unadjusted 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 consider whether these misstatements are indications of weaknesses in the internal controls related to budget execution. If audit evidence indicates that internal controls might not provide reasonable assurance that the entity executed transactions in accordance with budget authority, the auditor should discuss the legal implications with OGC.

COMPLIANCE CONTROLS

.13 Based on the results of compliance control tests and other audit procedures, the auditor must:

- conclude whether the entity's internal controls provide reasonable assurance that the entity complied with the significant provisions of laws and regulations as of the end of the period (to support the opinion on management's assertion about the effectiveness of internal controls) and during the period (to test compliance as discussed in section 460).

- report weaknesses in compliance controls that come to the auditor's attention (see paragraphs 580.31-.57).

If compliance controls are effective in preventing or detecting noncompliance with relevant provisions of laws and regulations during the period, the extent of compliance testing can be less than if such controls were not effective as discussed in section 460.

OPERATIONS CONTROLS

.14 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 performing other audit procedures. Based on gaining an understanding of performance measures systems and other procedures (which may include tests of controls, but which are not required), the auditor will have an understanding of performance measures controls as they relate to the existence, completeness, and valuation assertions, in order to assess the design of the controls and whether they have been placed in operation. The auditor should

- conclude as to whether internal control policies and procedures are properly designed and placed in operation (this does not require concluding as to operating effectiveness) and

- report weaknesses in performance measures controls that come to the auditor's attention. See paragraphs 580.31-.57 regarding reporting of control weaknesses.

REEVALUATION OF CONTROL RISK AND COMBINED RISK ASSESSMENT

.15 After completing the testing phase, discussed in section 400, the auditor should reevaluate the preliminary assessment of control risk for financial reporting controls and control effectiveness for budget, compliance and operations controls. If the tests results are contrary to the preliminary assessment, the auditor should reconsider the adequacy of the audit procedures performed and perform additional procedures as considered necessary.

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380 - OTHER CONSIDERATIONS

ROTATION TESTING OF CONTROLS

.01 When the entity's control environment is strong and inherent risk is low, using a rotation approach for testing controls may be appropriate for EDP-related controls. When appropriate, based primarily on favorable results from prior tests and limited work in the current year, the auditor may test EDP-related internal controls of certain cycles/applications on a rotating basis rather than every year. Rotation is not appropriate for use in first-time audits or for audits of entities that do not have strong control environments. Section 395 G provides additional requirements and guidelines for rotation testing of controls.

PARTIAL-YEAR CONTROLS

.02 In certain situations, such as when new controls are implemented during the year, the auditor may elect to test controls only for the period that the new controls were operating. In such situations, the extent of control testing should remain similar, but be concentrated over the period the new controls are in place. For any portion of the audit period that financial reporting, budget, and compliance controls were not tested directly or through a rotation plan (see paragraph 380.01), the auditor should assume that such controls were ineffective for purposes of designing compliance and substantive tests.

PLANNED CHANGES IN CONTROLS

.03 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 and test controls in effect through the end of the audit period to (1) provide support for the report on internal controls, (2) recommend any improvements to the current system that should be considered in designing the new systems or controls, and/or (3) obtain audit evidence to reduce substantive testing in the current audit. During the current audit, the auditor may elect to review controls designed into the new system.

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390 - DOCUMENTATION

.01 In addition to preparing a control testing audit program and other workpapers relevant to the internal control phase, the auditor should prepare the documents described in paragraphs 390.04-.07.

.02 In the audit program, the auditor generally should explain the objectives of audit procedures. Also, written guidance either within or accompanying the audit program to explain possible exceptions, their nature, and why they might be important, may help auditors focus on key matters, more readily determine which exceptions are important, and identify significant exceptions.

.03 As the audit work is performed, the auditors may become aware of possible reportable conditions or other matters which should be communicated to the auditee. The auditor generally should document and communicate these as described in paragraph 290.02.

CYCLE MEMORANDUM AND FLOW CHART

.04 For each significant cycle, the auditor should prepare a cycle memorandum and a complementary flow chart of the cycle and component accounting application(s). To the extent relevant, these documents should include the following accounting systems information for financial reporting controls:

- The **cycle memorandum** should (1) identify the cycle transactions and each significant accounting application included in the cycle, (2) describe interfaces with other cycles, (3) identify financial statement line items and general ledger accounts included in the cycle, (4) describe the operating policies and procedures relating to the processing of cycle transactions (see paragraph 320.02),[1] and (5) identify major internal controls (overview only).

- The **flow chart** should complement the related cycle memorandum and should summarize the significant transaction flows in terms of (1) input and report documents, (2) processing steps, (3) files used, (4) units

[1] Specific relevant control techniques will be documented later in the specific control evaluation worksheet, after related control objectives have been identified. (See paragraphs 330.02-.11.)

involved, and (5) interfaces with other cycles and accounting applications.[2]

.05 The auditor should document the understanding of budget, compliance, and relevant operations control systems in a memorandum and, if applicable, a flow chart addressing each point discussed in paragraphs 320.03-.05.

SPECIFIC CONTROL EVALUATION WORKSHEET

.06 The auditor should document the evaluation of specific control techniques in the SCE worksheet. Control tests should be documented in a control test audit program and in accompanying workpapers. Any EDP-related procedures should also be documented in the audit workpapers, as discussed in paragraph 370.05. Section 395 H presents an example of a completed SCE worksheet.

UPDATING THE ACCOUNT RISK ANALYSIS FORM

.07 The auditor should update the ARA form by completing the internal control phase columns, as illustrated in section 395 I.

[2] Although the auditor may gather information on control techniques in preparing the flow chart, such techniques should be documented in the SCE worksheet, if applicable, and need not be documented in the flow chart.

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 related line item or account. In turn, control objectives and relevant control techniques to achieve those objectives should be identified.

Line Items/ Accounts	Transaction-Related Accounting Applications					Line Item/Account-Related Accounting Applications				
	Billing	Cash Receipts	Purchasing	Cash Disbursements	Payroll	Cash	Accounts Receivable	Inventory	Property	Accounts Payable
Cash		X		X	X	X				
Accounts Receivable	X	X					X			
Inventory	X		X					X		
Property			X						X	
Liabilities			X	X						X
Revenue	X									
Expenses			X		X					

395 B - FINANCIAL STATEMENT ASSERTIONS AND POTENTIAL MISSTATEMENTS

This section lists potential misstatements that could occur in each financial statement assertion within an accounting application, together with related control objectives. The auditor should use judgment to tailor this information to the accounting application and to the entity and should consider supplementing this list with other control objectives or subobjectives. The assertions, potential misstatements, and control objectives illustrated in this section can be used in preparing the first, fourth, and fifth columns of the SCE worksheet, which is illustrated in section 395 H. However, this section is provided as a reference and does not require completion as a form.

ASSERTION	POTENTIAL MISSTATEMENT	CONTROL OBJECTIVE
	Transaction-Related	
Existence or Occurrence	Validity: 1. Recorded transactions do not represent economic events that actually occurred.	1a. Recorded transactions, underlying events, and related processing procedures should be authorized by federal laws, regulations, and management policy. 1b. Recorded transactions should be approved by appropriate individuals in accordance with management's general or specific criteria. 1c. Recorded transactions should represent events that actually occurred and should be properly classified.
	Cutoff: 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 should represent economic events that occurred during the current period.
	Summarization: 3. Transactions are summarized improperly, resulting in an overstated total.	3. The summarization of recorded transactions should not be overstated.

ASSERTION	POTENTIAL MISSTATEMENT	CONTROL OBJECTIVE
	Line Item/Account-Related	
	Substantiation: 4. Recorded assets and liabilities do not exist at a given date.	4a. Recorded assets and liabilities should exist at a given date. 4b. Recorded assets and liabilities of the entity, at a given date, should be supported by appropriate detailed records which are accurately summarized and reconciled to the account balance. 4c. Access to assets, critical forms, records, and processing and storage areas should be permitted only in accordance with laws, regulations, and management policy.
	Transaction-Related	
Completeness	Transaction Completeness: 5. Valid transactions are not recorded.	5. All valid transactions should be recorded and properly classified.
	Cutoff: 6. Economic events occur in the current period, but the related transactions are recorded in a different period.	6. All economic events that occurred in the current period should be recorded in the current period.
	Summarization: 7. Transactions are summarized improperly, resulting in an understated total.	7. The summarization of recorded transactions should not be understated.
	Line Item/Account-Related	
	Account Completeness: 8. Assets and liabilities of the entity exist but are omitted from the financial statements.	8. All accounts that belong in the financial statements should be so included. There should be no undisclosed assets or liabilities.

ASSERTION	POTENTIAL MISSTATEMENT	CONTROL OBJECTIVE
Valuation or Allocation	Transaction-Related	
	Accuracy: 9. Transactions are recorded at incorrect amounts.	9. Transactions should be recorded at correct amounts.
	Line Item/Account-Related	
	Valuation: 10. Assets and liabilities included in the financial statements are valued on an inappropriate basis.	10. Assets and liabilities included in the financial statements should be valued on an appropriate valuation basis.
	Measurement: 11. Revenues and expenses included in the financial statements are measured improperly.	11. Revenues and expenses included in the financial statements should be properly measured.
Rights and Obligations	Line Item/Account-Related	
	Ownership: 12. Recorded assets are owned by others because of sale, consignment, or other contractual arrangements.	12. Recorded assets should be owned by the entity.
	Rights: 13. The entity does not have certain rights to recorded assets because of liens, pledges, or other restrictions.	13. Assets should be the entity's rights at a given date.
	Obligations: 14. The entity does not have an obligation for recorded liabilities at a given date.	14. Liabilities should be the entity's obligations at a given date.
Presentation and Disclosure	Line Item/Account-Related	
	Account Classification: 15. Accounts are not properly classified and described in the financial statements.	15. Accounts should be properly classified and described in the financial statements.
	Consistency: 16. The financial statement components are based on accounting principles different from those used in prior periods.	16. The financial statement components should be based on accounting principles that are applied consistently from period to period.

ASSERTION	POTENTIAL MISSTATEMENT	CONTROL OBJECTIVE
	Disclosure: 17. Required information is not disclosed in the financial statements or in the footnotes thereto.	17. The financial statements or footnotes thereto should contain all information required to be disclosed.
	Transaction-Related	
See Note Below	Segregation of Duties: 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 should be prevented from having uncontrolled access to both assets and records.

Note: 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 perpetrate and conceal errors or irregularities. The lack of segregation-of-duties controls may be pervasive and affect several misstatements. Paragraph 330.08 discusses when segregation-of-duties controls should be tested.

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395 C - TYPICAL CONTROL TECHNIQUES

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, and management policy. Typical authorization controls include:

- Documented policies establish events or transactions that the entity is authorized to engage in by law, regulation, or management policy.

- Documented policies and procedures exist for processing transactions in accordance with laws, regulations, or management policy.

- Master files 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 include:

- Specific 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.

- 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 on-line approval of input before processing.

SEGREGATION OF DUTIES

.03 Segregation-of-duties controls are designed to reduce the opportunities for someone to both perpetrate and conceal errors or irregularities in the normal course of duties. Typically, an entity achieves adequate segregation of duties by establishing controls (such as segregating asset custody from record-keeping functions) to prevent any person from having uncontrolled access to both assets and records. See paragraphs 330.08 and 360.11 for additional discussions of segregation-of-duties controls.

DESIGN AND USE OF DOCUMENTS AND RECORDS

.04 The purpose of controls over the design and use of records is to help provide reasonable assurance that transactions and events are properly recorded. Such controls typically include the following policies and procedures:

- Pre-numbered forms are used to record all of an entity's transactions, and accountability is maintained for the sequence of all numbers used. (For example, pre-numbered 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, etc., 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 that occurred 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 on a timely basis.

- 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 recording transactions more than once. Also, only original documents are used to process transactions.

ADEQUATE 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. Evaluation of segregation of duties also is required for persons who have authorized access to assets and records. Typical access controls follow:

- Cash receipt totals are recorded before cash is transmitted for deposit.

- 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 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.)

- 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 given up only on the basis of proper authorization (such as a purchase order, contract, or shipping order) in accordance with established procedures.

- Procedures are established to 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 in this category are designed to provide independent checks on the validity, accuracy, and completeness of processed data. The following procedures are typical of this category of controls:

- Calculations, extensions, additions, and accounting classifications are independently reviewed. (For example, arithmetic on vouchers is independently recomputed, 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 cash receipts detailed listing 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 OF RECORDED AMOUNTS

.07 Controls in this category are designed to provide assurance that assets are valued at appropriate amounts. Typical valuation controls follow:

- Periodically, the condition and marketability of assets are evaluated. (For example, inventory is periodically reviewed for physical damage, deterioration, or obsolescence or receivables are evaluated for collectibility).

- 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 assurance that transactions are accurately summarized and that any adjustments are valid. Typical controls in this category include:

- The sources of summarized data (such as subsidiary 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, journal entries are compared to source documents, and the daily summaries of journal entries are compared with 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 application to another are compared).

RIGHTS AND OBLIGATIONS

.09 Controls in this category are designed to provide 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 legal obligations at a given date. The following procedures are typical of this category of controls:

- 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

.10 Controls in this category are designed to provide assurance that (1) accounts are properly classified and described in the financial statements, (2) the financial statements are prepared in conformance with the applicable accounting principles (i.e., those contained in entity accounting policy or procedures manuals, and/or related guidance), and (3) footnotes contain all information required to be disclosed. The following procedures are typical of this category of controls:

- Policies and procedures are documented for accumulating and disclosing financial information in the financial statements by appropriate personnel. Responsibility is assigned to specific individuals.

- Policies and procedures are documented for preparing financial statements by authorized personnel having sufficient experience and expertise to assure compliance with applicable accounting principles.

- Policies and procedures are documented (such as policy and procedures manuals, together with organization charts) for properly classifying and describing financial information in the financial statements.

- Reports are periodically substantiated and evaluated by supervisory personnel. Procedures are implemented to detect errors and omissions and to evaluate recorded balances.

- A written chart of accounts containing a description of each account is used. Journal entries are prepared, reviewed, compared with supporting details where necessary, and approved each accounting period.

- Appropriate processing procedures are used, including control or batch totals, etc. 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.

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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 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, 1349-1351, and 1511-1517 for further information.)

.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.) Annual appropriations often are referred to as "fixed accounts." Appropriations also may be authorized for the length of a project, which can span several years. These accounts often are referred to as "no year" accounts.

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395 E - DESCRIPTION OF BUDGET EXECUTION STEPS

.01 The following budget execution steps are of interest to the auditor when evaluating an entity's internal controls relating to budget execution:

- **An appropriation (or other budget authority)** is authority provided by law to enter into obligations which will result in immediate or future outlays involving Government funds or to collect offsetting receipts (2 U.S. 622(2)). Because the Congress provides an entity with budget authority, such authority is legally binding on the entity. An appropriation is considered expired when, according to the restrictions contained in the appropriation, the appropriation is no longer available for new obligations.

- **Warrants** are issued by the Secretary of Treasury and used as the basis for recording appropriations on the books of Treasury and the entities.

- **An apportionment** is a distribution made by OMB of amounts available for obligation. Apportionments divide amounts available for obligation by specific time periods (usually quarters), activities, projects, or objects, or a combination thereof. The amounts so apportioned limit the amount of obligations that may be incurred.

- **An allotment** is an authorization by the head (or other authorized employee) of an entity to subordinates to incur obligations within a specified amount. An entity makes allotments pursuant to the requirements stated in OMB Circular A-34 (A-34). The total amount allotted by an entity should not exceed the amount apportioned by OMB. The entity, through its fund control regulations, may establish allotments as a legally binding level for complying with the Antideficiency Act. Suballotments and allowances are the same type of authorization but at a more detailed level (i.e., suballotments are divisions of allotments).

- **A commitment** is a proposed obligation. Commitments are tracked by entities and are used for financial planning and control. Entities are not required to use commitments in the budget accounting system.

- **An obligation** is the amount of orders placed, contracts awarded, services received, and similar transactions during a given period that will require payments during the same or future periods. Obligations have to satisfy legal requirements before they may be properly recorded against appropriation accounts (Title 7). These legal requirements include consideration of 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 only to orders for goods and services that have not been delivered (undelivered orders).

- **An expenditure** is the liquidation of an obligation by the receipt of goods and services ordered. An "expended appropriation" means that the appropriation authority has been used to acquire goods or services and thus is no longer available. The term "outlay," as used in the President's budget and Congressional budget documents, has the same meaning as the term "expenditure." In other contexts, outlay refers to payments for goods and services. This manual limits the use of "outlay" to refer to these payments.

- **Adjustments to expired accounts** are "increases or decreases to commitments, obligations, or expenditures [of prior period obligations]. Adjustments include recording commitments, obligations, or expenditures that were made or incurred during the period prior to expiration of the account, but not recorded" (A-34). No new obligations can be created. Adjustments may be recorded for 5 years after the appropriation expires. After the 5-year period, the budget authority for the expired accounts is canceled and the accounts are closed. Payments for any outstanding unliquidated obligations in closed accounts may be made from current year appropriations which have the same general purpose (but limited in aggregate to 1 percent of the current year appropriation). For both expired accounts and closed accounts, the entity's obligations and expenditures may not exceed the related budget authority. The auditor should refer to A-34, part XI (issued as part of OMB Bulletin 91-07); for additional guidance on these types of adjustments and transactions.

  Examples of valid adjustments to expired accounts include adjustments for (1) canceled orders or orders for which delivery is no longer likely, (2) refunds received in the current period that relate to recovery of erroneous payments or accounting errors, (3) legal and valid obligations

that were previously unrecorded, and (4) differences between the estimated and actual obligation amounts.

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395 F - BUDGET CONTROL OBJECTIVES

.01 This section lists budget control objectives by steps in the budget execution process.

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 legislation, 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.[1]

c. **Allotments/suballotments:** The total amount allotted does not exceed the total amount apportioned.

d. **Commitments:** The auditor is generally not concerned with controls over budgetary commitments because commitments are not legally binding restrictions. Controls over budgetary commitments are considered a type of operations control.

The auditor should consider evaluating controls over commitments if the entity is using commitments and relying on controls over commitments to achieve the control objectives relating to obligations. If controls over commitments are evaluated, the auditor should apply the same control objectives used for obligations and expenditures, as discussed below.

[1] OMB apportionments may be less than the amount of the apportionments requested by the entity due to impoundments (rescissions or deferrals). The auditor should notify OGC of any impoundments that come to the auditor's attention.

e. **Obligation transactions:** The following control objectives relate to obligation transactions (undelivered orders):

- **Validity:** Obligations recorded are valid. An obligation is considered 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 binding contract.

    The auditor should be alert for instances of "block obligating" or "block dumping," which occurs when an entity records obligations to "reserve" funds, even though the goods or services have not been ordered. This is most likely to occur near the expiration of the appropriation. The auditor should be alert 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 multi-year 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 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, identified in the planning phase.

  - For adjustments to obligations in expired accounts, the following objectives also are to be met:

    - If the adjustment represents a "contract change" as defined in OMB Circular A-34, the auditor should refer to part XI, paragraph 111.7, of that circular for reporting and approval requirements.

- The adjustment does not cause the entity to exceed the amount appropriated by statute.

- The adjustment is recorded during the period when the account is available for adjustments (5 years).

- New obligations may not be recorded in expired accounts.

- **Completeness:** All obligation transactions are recorded.

- **Valuation:** 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 accounts (both by program and by object, if applicable), including the proper appropriation year if the account has multiple years. 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. **Expenditure transactions:** The following control objectives relating to expenditure transactions, as defined in section 395 E, are generally the same as those for obligation transactions:

- **Validity:** For all expenditures, recorded expenditures have occurred. This occurrence is usually evidenced by appropriate supporting documentation. For expenditures (or adjustments to expenditures) in expired accounts, the following objectives also are to be met:

  - The expenditure does not cause the entity to exceed the amount appropriated by statute

  - The expenditure is recorded during the period when the account is available for adjustments (5 years).

  - The expenditure is not made out of a closed account.

- **Completeness:** All expenditures and adjustments are recorded.

- **Valuation:** Expenditures and adjustments are recorded at the correct amount.

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

- **Classification**: Expenditures and adjustments are recorded in the proper accounts (both by program and by object, if applicable), including the proper appropriation year if the account has multiple years.

g. **Obligation and expenditure balances:** The following control objectives relate to obligation and expenditure balances as of a point in time:

- **Summarization:** Recorded balances of obligation and expenditure accounts as of a given date are supported by appropriate detailed records that are accurately summarized and reconciled to the account balance, by year, for each account.

- **Substantiation:** Recorded account balances are supported by valid obligations and expenditures.

- **Limitation:** Total obligations plus total expenditures do not exceed the amount of the appropriation or other statutory limitations (such as obligation ceilings) that may exist by appropriation period. These other statutory limitations may concern the amount by program or object classification. Additionally, total payments of outstanding unliquidated obligations that relate to closed accounts cannot exceed the limits described in A-34, Part XI, 111.4 (for annual accounts, 1% of the accounts current year appropriation, for multi-year accounts, 1% of all appropriations that have not expired for obligational purposes for the account).

h. **Appropriation account balances:** The following control objectives relate to appropriation account balances as of a point in time:

- Fixed appropriation accounts are identified by fiscal year after the end of the period they are available for obligation until they are closed. (31 USC 1553(a))

- Fixed appropriation accounts are closed on September 30th of the 5th 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 cancelled and is no longer available for obligation or expenditure for any purpose. (31 USC 1552(a)). For example, at the end of fiscal year 1995, the entity should only have accounts for fixed appropriations that expired at the end of fiscal years 1991, 1992, 1993, 1994, and 1995. All fixed appropriations that expired prior to these dates should have been closed and cancelled as of the end of fiscal year 1995.

- 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 <u>and</u> (2) no disbursement has been made against the appropriation for two consecutive fiscal years. (31 USC 1555)

i. **Recording of cash receipts related to closed appropriation accounts:** (To be considered only if such amounts are expected to exceed design materiality.)

- 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 USC 1552(b))

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395 F Sup - BUDGET CONTROL OBJECTIVES - FEDERAL CREDIT REFORM ACT SUPPLEMENT

.01 The Federal Credit Reform Act (FCRA) contains numerous provisions relating to 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 included in the notes to this supplement.) For transactions and account balances related to these types of activities, the auditor should consider each of the budget control objectives listed in FAM 395 F and supplement them with the following additional budget control objectives related to FCRA. Additional guidance on FCRA accounting for budget purposes is included in OMB Circular A-34, part VI, Credit Apportionment and Budget Execution.

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 (except modifications within the terms of existing contracts or through other existing authorities). The following are supplemental control objectives related to obligation transactions under FCRA:

- **Valuation:** Obligations are recorded at the best available estimate of actual cost.

  - The cost of a direct loan is recorded as the net present value, at the time when the loan is disbursed, of the following cash flows:

    - loan disbursements,
    - estimated principal repayments,
    - estimated interest payments, and
    - estimated amounts and timing of any other payments by or to the government over the life of the loan. These amounts include fees, penalties, and other recoveries. Administrative costs and any incidental effects on governmental receipts and outlays are excluded. (2 USC 661a(5)(A) and (B))

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

- The cost of a loan guarantee is recorded as the net present value, at the time when the related guaranteed loan is disbursed, of the following cash flows:

  - estimated amounts and timing of payments by the government for defaults, delinquencies, interest subsidies, or other payments, excluding administrative costs; and

  - estimated amounts and timing of payments to the government for origination and other fees, penalties, and recoveries. (2 USC 661a(5)(A) and (C))

  Any incidental effects on governmental receipts and outlays are excluded. These cash flows are discounted using the appropriate rate as described below.

- The cost of a modification is recorded as the difference between the current estimated net present value of the cash flows under the existing direct loan or guarantee contract and the estimated net present value of the cash flows under the modified contract. The cash flows for each of these calculations is discounted at the rate for modifications described below. (2 USC 661a(5)(D))

- The discount rate used to estimate the net present values described above is the average interest rate, in effect when the obligation is incurred, for marketable Treasury securities of similar maturity to the related loan. For modifications, the discount rate used is the average rate, in effect at the time of modification, for marketable Treasury securities with a maturity similar to the remaining maturity of the modified loan. (2 USC 661a(5)(E))

b. **Expenditure transactions:** Expenditure transactions include transactions that occur when loans are disbursed. The following are supplemental control objectives related to expenditure transactions under FCRA:

- **Valuation:** Expenditures are recorded at the proper amount. The same specific criteria for the amounts of FCRA obligations are also applicable to expenditures.

- **Cutoff:** Expenditures are recorded in the proper period.

  - Expenditures for the cost of loans or guarantees are recorded in the fiscal year in which the direct or guaranteed loan is disbursed or its costs altered. (2 USC 661c(d)(2))

- **Classification/Presentation and Disclosure:** Amounts are recorded in the proper account and reported appropriately.

  - Differences in subsequent years between original estimated cost 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 USC 661c(f))

  - Funding for the administration 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 USC 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 USC 661a(7))

c. **Obligation and expenditure balances:** The following are supplemental control objectives related to obligation and expenditure balances under FCRA as of a point in time:

- **Limitation:** Total obligations plus total expenditure transactions do not exceed the amount of the appropriation or other statutory limitations that may exist by appropriation period.

  - 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. (Discuss applicability of this budget restriction to direct loans and direct loan obligations that were outstanding prior to October 1, 1991 with OGC prior to performing control or compliance tests.)

- 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. (Discuss applicability of this budget restriction to loan guarantees, or loan guarantee commitments that were outstanding prior to October 1, 1991 with OGC prior to performing control or compliance tests.)

d. **Cash receipts:** The following are supplemental control objectives related to cash receipts under FCRA

- **Classification:** Cash receipts are recorded in the proper account.

  - Cash receipts related to direct loans obligated or loan guarantees committed prior to October 1, 1991 are recorded in the liquidating accounts. (2 USC 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 USC 661a(7))

Note 1: A **direct loan** is a disbursement of funds by the government to a non-federal borrower under a contract that requires the repayment of such funds with or without interest. The term also includes the purchase of, or participation in, a loan made by another lender. The term does not include the acquisition of a federally guaranteed loan in satisfaction of default claims or the price support loans of the Commodity Credit Corporation. (2 USC 661a(1))

Note 2: A **direct loan obligation** is a binding agreement by a federal agency to make a direct loan when specified conditions are fulfilled by the borrower. (2 USC 661a(2))

Note 3: A **loan guarantee** is any guarantee, insurance, or other pledge with respect to the payment of all or a part of the principal or interest on any debt obligation of a non-federal borrower to a non-federal lender, but does not include the insurance of deposits, shares, or other withdrawable accounts in financial institutions. (2 USC 661a(3))

Note 4: A **loan guarantee commitment** is a binding agreement by a federal agency to make a loan guarantee when specified conditions are fulfilled by the borrower, the lender, or any other party to the guarantee agreement. (2 USC 661a(4))

Note 5: **Costs** are defined as the estimated long-term cost to the government of a direct loan or loan guarantee, calculated on a net present value basis, excluding administrative costs and any incidental effects on governmental receipts or outlays (2 USC 661a(5)). These calculations are described in further detail under the valuation control objective for obligations in FAM 395 F.

Note 6: A **credit program account** is a budget account associated with each program account into which an appropriation to cover the cost of a direct loan or loan guarantee program is made and from which such cost is disbursed to the financing account. (2 USC 661a(6))

Note 7: A **liquidating account** is a budget account that includes 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 required to be shown on a cash basis. (2 USC 661a(8))

Note 8: A **financing account** is a non-budget account(s) associated with each credit program account that holds balances, receives the cost payment from the credit program account, and also includes 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 USC 661a(7))

Note 9: **Modifications** are government actions that alter the estimated net present value of a direct loan or loan guarantee for which an obligation has been recorded; for example, a policy change affecting the repayment period or interest rate for a group of existing loans. Changes within the terms of existing contracts or through other existing authorities are not considered modifications under FCRA. Additionally, "work outs" of individual loans, such as a change in the amount or timing of payments to be made, are not considered modifications. The effects of these changes should be included in the annual reestimates of the estimated net present value of the obligations.

Note 10: OMB A-34, part VI, paragraph 62.8 instructs agencies to make annual **reestimates** 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 the timing of payments. Permanent indefinite authority has been provided for reestimates.

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395 G - ROTATION TESTING OF CONTROLS

OVERVIEW

.01 Rotation testing of controls, as discussed in paragraph 380.01, may be considered for testing financial reporting controls of an entity with multiple significant accounting cycles/applications, provided that effective financial reporting controls within all significant cycles/applications have been evaluated and tested within a sufficiently recent period of years. Under a rotation plan, such controls are tested in different cycles/applications each year such that each cycle/application is selected for testing, as described in sections 310-380, at least once during a rotation period of several years, but not necessarily every year. For example, a rotation plan for an entity with five significant cycles/applications might include tests of two or three cycles/applications annually, covering all cycles/applications in a two or three year period. Rotation testing should be limited to computerized applications that have strong computer general controls because computer programs ordinarily function consistently in the absence of programming changes, reducing the probability of random errors.

.02 Less extensive procedures (limited tests) must be performed annually for financial reporting controls in significant cycles/applications not selected for testing. Limited tests consist of:

- updating the auditor's understanding of the control environment, accounting system, and financial reporting control techniques, including performing walkthroughs; and

- performing any other procedures that may be necessary under the specific circumstances to support the report on internal controls and the evaluation of internal controls relied on in performing certain audit procedures..

.03 The auditor's decision to use rotation is made on a cycle-by-cycle or application-by-application basis, so some cycles/applications might be tested annually and others by rotation. In rotation testing, the auditor relies on

cumulative audit evidence and knowledge, including that gathered in prior years, to support the assessment of and report on internal controls. Accordingly, rotation may be used only when all the following conditions exist:

- The auditor possesses a "foundation" of audit evidence on which to develop current audit conclusions.

- Control risk is low, the control environment is strong, and inherent risk factors are reasonably low.

- Financial reporting controls over all significant cycles/applications have been evaluated and tested during a sufficiently recent period (generally within 3 years).

- Recurring audits of the entity enable a rotation plan to be effective (Some of GAO's audits are presently nonrecurring.)

- No specific reporting or risk issues preclude the use of rotation. (For example, cycles/applications do not affect such sensitive areas as loan loss reserves.)

.04 Ordinarily, the following cycles/applications should be subjected to tests of financial reporting controls and should be excluded from rotation testing:

- any cycle/application that is disproportionately significant.

- any cycle/application that has undergone major change since financial reporting controls were most recently tested.

.05 The foundation of audit evidence to support a rotation plan, which is updated and increased through limited tests and other relevant audit evidence, may be obtained from one or a combination of the following:

- evidence gathered in one or more prior GAO audits;

- the current or prior work of the IG, after the auditor considers the nature, timing, and extent of procedures applied by the IG in relation to the audit objectives; and

- the current or prior work of internal or other auditors or consultants to the entity, after the auditor performs procedures to rely on such work.

CIRCUMSTANCES UNDER WHICH ROTATION TESTING MAY BE USED

.06 The auditor should exercise considerable judgment in determining whether to use rotation. Factors that the auditor should consider include the following:

- The results and extent of the auditor's prior experiences with the entity and its cycles/applications, including the length of time since financial reporting controls were tested.

  The effectiveness of prior evidence ordinarily diminishes with the passage of time.

- The importance of the cycles/applications to the overall entity, and the nature of the audit assertion or assertions involved.

  As the significance of cycles/applications and assertions increases, the frequency of testing thereof ordinarily increases.

- The auditor's assessment of inherent risk.

  The effectiveness of rotation ordinarily diminishes as inherent risk increases.

- The auditor's preliminary assessment of control risk.

  The effectiveness of rotation ordinarily diminishes rapidly as control risk increases.

- The extent to which control is centralized or decentralized.

  The effectiveness of rotation ordinarily diminishes rapidly as control becomes more decentralized.

- The number and relative sizes of the respective cycles/applications.

  The efficiency of rotation ordinarily increases as the number and size of cycles/applications increase.

- The nature and extent of audit evidence about internal controls that may result from substantive testing in the current audit.

  Information obtained concurrently with substantive testing might provide evidence about the functioning of cycles/applications.

- The extent of oversight provided by the IG and others.

  Work performed by the IG and others might be used to reduce tests of financial reporting controls.

- Any special reporting or entity requirements.

  The auditor should perform sufficient tests to meet any special requirements, such as a special report on the functioning of a specific cycle/application.

.07 For any rotation testing plan, the auditor should document in a memorandum approved by the Director of Planning and Reporting:

- the schedule for testing all significant cycles/applications;

- the reasons for using such a plan;

- any limitations on the use of such a plan; and

- any other significant aspects, including descriptions of any modifications to rotation plans established in previous years. A rotation plan should be re-evaluated annually.

395 H - SPECIFIC CONTROL EVALUATION WORKSHEET

The auditor should use the SCE worksheet to document the evaluation of control techniques in the internal control phase. This section illustrates an SCE worksheet for the cash receipts application for a hypothetical federal government entity, "XYZ Agency" (XYZ). (See page 395 H-3.)

An SCE worksheet should be prepared for each significant accounting application. The auditor generally should use the SCE worksheet to document the evaluation of budget, compliance, and operations controls. The worksheet may be completed for financial reporting controls as follows:

1. List each assertion that is relevant to the accounting application. While all five financial statement assertions relate to line item/account-related accounting applications, the existence or occurrence, completeness, and valuation assertions relate principally to transaction-related accounting applications, as illustrated at section 395 B. Therefore, assertions relevant to cash receipts would be existence or occurrence, completeness, and valuation.

2. From the Account Risk Analysis (see section 240), list the significant line items or accounts that the accounting application affects. For example, cash and accounts receivable are ordinarily affected by cash receipts.

3. Document the assertions for each of the line items or accounts identified in step 2 that relate to each accounting application assertion (see section 330).

4. For each significant account assertion, identify the potential misstatements that could occur in the accounting application and the related control objectives, based on the generic list of potential misstatements and control objectives included in section 395 B.

This list should be tailored to the accounting application and the entity and, if necessary, should be supplemented with additional objectives or sub-objectives.[1]

5. List control techniques selected for testing that achieve each control objective identified above, and indicate whether each is EDP-related. section 395 C illustrates typical control techniques to achieve financial reporting control objectives.

6. Document the effectiveness of control techniques in achieving the control objectives, in relation to each potential misstatement, and cross-reference to the audit procedures in the testing program. (The overall assessment of financial reporting controls should be documented in the ARA document as illustrated in section 395 I.)

[1] In the SCE worksheet, the auditor may either commingle the documentation of budget, compliance, and operations controls with that of financial reporting controls to the extent relevant or present each of these types of controls in a separate SCE. To complete the SCE worksheet for these controls, the auditor begins by inserting relevant control objectives and performs steps 5 and 6 above.

ENTITY: *XYZ Agency (XYZ)* **SPECIFIC CONTROL EVALUATION** PREPARER _____

DATE OF FIN. STMTS: *9/30/92* FILE: _____ REGION _____

ACCOUNTING APPLICATION: *Cash Receipts* DATE _____ Page ___ of ___

ACCOUNTING APPLICATION: CASH RECEIPTS

ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL TECHNIQUES	EDP (Y/N)	EFFECTIVE-NESS OF CONTROL TECHNIQUES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
Existence or Occurrence	*Existence or Occurrence*	*Completeness*	*Validity:* *1. Receipt is recorded, but cash is not received.*	*1a. Recorded cash receipts and cash receipt processing procedures should be authorized by federal laws, regulations, and management's policy.*	*1a. Receipts processing is governed by documented procedures for accepting, obtaining, reviewing, and approving receipts.*	*N*	*Effective*	[In this column, the auditor would indicate, by cross-referencing, the audit procedures in the detailed control testing audit program that were designed to test each effective control determined to be relevant. Such tests will involve inquiry, observation, inspection, or a combination thereof.]
				1b. Recorded receipts should be approved by appropriate individuals in accordance with management's general or specific criteria.	*1b. Supervisory review is made of receipts processing to provide reasonable assurance that procedures are followed.*	*N*		

ENTITY: *XYZ Agency (XYZ)* **SPECIFIC CONTROL EVALUATION** PREPARER _____

DATE OF FIN. STMTS: *9/30/92* FILE: _____ REGION _____

ACCOUNTING APPLICATION: *Cash Receipts* DATE _____ Page ___ of ___

ACCOUNTING APPLICATION: CASH RECEIPTS

ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL TECHNIQUES	EDP (Y/N)	EFFECTIVE-NESS OF CONTROL TECHNIQUES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
				1c. Recorded receipts should represent amounts actually received by the entity and should be properl y classified.	*1c1. Recorded cash receipts are matched with the appropriate supporting documentation.*	*N*		
					1c2. Entries to the accounting records are reviewed and approved by supervisory personnel.	*N*		
			Cutoff: *2. Receipt is recorded in this period, but the cash is received in a different period.*	*2. Cash receipts recorded in the period should be actually received in the period.*	*2. Recorded receipts are reconciled to cash receipts listings and bank deposit reports before posting.*	*Y*	*Effective*	
			Summarization: *3. Receipt transactions are overstated due to improper summarization.*	*3. The summarization of receipt transactions should not be overstated.*	*3a. Receipt data in the general ledger is reconciled to subsidiary cash ledgers and records.*	*Y*	*Effective*	

ENTITY: *XYZ Agency (XYZ)* | **SPECIFIC CONTROL EVALUATION** | PREPARER _____

DATE OF FIN. STMTS: *9/30/92* | FILE: _____ | REGION _____

ACCOUNTING APPLICATION: *Cash Receipts* | DATE _____ Page ___ of ___

ACCOUNTING APPLICATION: CASH RECEIPTS

ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL TECHNIQUES	EDP (Y/N)	EFFECTIVE-NESS OF CONTROL TECHNIQUES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
					3b. Batch totals of input documents are reconciled to output registers, journals, reports, or file updates.	*Y*		
Completeness	*Completeness*	*Existence or Occurrence*	*Transaction Completeness:* *4. Cash is received, but receipt is not recorded.*	*4. All receipts of cash should be promptly 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.*	*N*	*Effective*	
					4b. Supervisory reviews of the processing of cash receipts.	*N*		

ENTITY: *XYZ Agency (XYZ)* **SPECIFIC CONTROL EVALUATION** PREPARER _____

DATE OF FIN. STMTS: *9/30/92* FILE: _____ REGION _____

ACCOUNTING APPLICATION: *Cash Receipts* DATE _____ Page ___ of ___

ACCOUNTING APPLICATION: CASH RECEIPTS

ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL TECHNIQUES	EDP (Y/N)	EFFECTIVE-NESS OF CONTROL TECHNIQUES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
			Cutoff: *5. Cash is received in this period, but receipt is recorded in a different period.*	*5. Cash receipts actually received in the period should be recorded in the period.*	*5. Same as procedure 2 above.*	*Y*	*Effective*	
			Summarization: *6. Receipt transactions are understated due to improper summarization.*	*6. The summarization of cash receipt transactions should not be understated.*	*6. Same as procedure 3a and 3b above.*	*Y*	*Effective*	
Valuation	*Valuation*	*Valuation*	*Accuracy:* *7. Receipt transactions are recorded at incorrect amounts.*	*7. Receipt transactions should be recorded accurately.*	*7a. Recorded receipts are compared with bank statements by persons who have no other receipts processing responsibilities.*	*Y*	*Effective*	
					7b. Supervisor reviews and approves reconciliations of recorded receipts to bank statements.	*N*		

ENTITY: *XYZ Agency (XYZ)* **SPECIFIC CONTROL EVALUATION** PREPARER _____

DATE OF FIN. STMTS: *9/30/92* FILE: _____ REGION _____

ACCOUNTING APPLICATION: *Cash Receipts* DATE _____ Page ___ of ___

ACCOUNTING APPLICATION: CASH RECEIPTS

ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL TECHNIQUES	EDP (Y/N)	EFFECTIVE-NESS OF CONTROL TECHNIQUES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
Segregation of Duties	*Various*	*Various*	*Segregation* *8. The entity is exposed to loss of cash receipts and various misstatements as the result of inadequate segregation of duties.*	*8. Persons should be prevented from having uncontrolled access to both cash receipts and records.*	*8a. No individual has uncontrolled access (direct or indirect) to both cash receipts and records.*	*N*	*Effective*	

Preparation Notes:

1. The third column is for use where 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 paragraph 330.05).

2. If there is inadequate segregation of duties, the auditor should identify the specific affected account assertions in columns 2 and 3.

395 I - ACCOUNT RISK ANALYSIS FORM

.01 The ARA form should be used by the auditor to summarize, for significant line items, specific risks of misstatement for consideration in determining the nature, timing, and extent of audit procedures. Any pervasive risks should be documented in the GRA and considered when designing audit procedures, but do not need to be documented on the ARA form. An ARA form should be prepared for each significant line item and should identify the significant accounts and related assertions.

.02 The form may be completed as the related activities are performed as follows:

Planning Phase:

1. List each significant account, account balance, and related significant financial statement assertions as discussed in section 235. Accounts that share the same risks and applications generally should be grouped together. As noted in paragraph 290.06, 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.

2. For each financial statement assertion, describe the related risk (see section 260).

3. From the GRA, summarize any specific inherent risks or control environment weaknesses identified.

4. List the significant cycles and accounting applications that affect each assertion.

Internal Control Phase:

5. For each cycle and accounting application, indicate the assessment of the effectiveness of the related control techniques for the assertion. This assessment should be obtained from the related SCE worksheet.

6. Assess the control risk for each assertion (see section 370) and document the assessment.

7. Assess the combined risk for each assertion (see section 370) and document the assessment.

Testing Phase:

8. Determine the nature, timing, and extent of audit procedures (see sections 420 and 430). Document a brief description of the procedure and reference to the step of the detailed audit program.

9. If the results of testing indicate that the preliminary assessments of control risk or combined risk were not appropriate, the revised assessments and a summary of the factors contributing to the revised assessment should be documented on the ARA and described in a memorandum, as appropriate.

Insignificant line items and accounts also may be documented on the ARA form rather than in the cycle matrix. Regardless, the auditor should determine and document that all accounts have been considered in the audit plan.

ENTITY: *XYZ Agency (XYZ)*

DATE OF FINANCIAL STATEMENTS: *9/30/92*

LINE ITEM: *Accounts Receivable - Net*

ACCOUNT RISK ANALYSIS FORM

FILE: _____

PREPARER_____

REGION _____

DATE _____ Page ___ of ___

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent Risks & Control Environment Weaknesses	Cycle/ Accounting Application	Effective-ness of Control Techniques	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
Accounts Receivable-Net	*$876,000,000*	***Existence or Occurrence:*** *Recorded accounts receivable do not exist.*	*No significant inherent risk or control environment weakness noted.*	*Sales/ Billing*	*Effective*	*Low*	*Low*	*F*	*Confirm balances, and test reconciliation of subsidiary ledger to the general ledger.*	*III-5 to III-7*
				Sales Returns	*Effective*					
				Cash Receipts	*Effective*					
				Accounts Receivable	*Effective*					

ENTITY: *XYZ Agency (XYZ)*

DATE OF FINANCIAL STATEMENTS: *9/30/92*

LINE ITEM: *Accounts Receivable - Net*

ACCOUNT RISK ANALYSIS FORM

FILE: _____

PREPARER_____

REGION _____

DATE _____ Page ___ of ___

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent Risks & Control Environment Weaknesses	Cycle/ Accounting Application	Effective-ness of Control Techniques	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
		Completeness: *Accounts receivable are not recorded timely so as to be included in the financial statements.*	*No significant inherent risk or control environment weakness noted.*	*Sales/ Billing*	*Effective*	*Low*	*Low*	*F*	*Perform analytical procedures. Test cut-off.*	*III-8 to III-12*
				Sales Returns	*Effective*					
				Cash Receipts	*Effective*					
				Accounts Receivable	*Effective*					

ENTITY: *XYZ Agency (XYZ)*

DATE OF FINANCIAL STATEMENTS: *9/30/92*

LINE ITEM: *Accounts Receivable - Net*

ACCOUNT RISK ANALYSIS FORM

FILE: _____

PREPARER_____

REGION _____

DATE _____ Page ___ of ___

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent Risks & Control Environment Weaknesses	Cycle/ Accounting Application	Effective-ness of Control Techniques	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
		Valuation or Allocation: *Accounts receivable are not valued accurately or on an appropriate basis in the financial statements.*	*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 control environment weakness noted.*	*Sales/ Billing* *Sales Return* *Cash Receipts* *Accounts Receivable*	*Effective* *Effective* *Effective* *Effective*	*Low*	*Moderate*	*F*	*Confirm balances (see existence), test the accuracy of the aging, analytically review bad debts and allowance, and examine evidence of collectibility for selected accounts receivable. Discuss collectibility from troubled debtors with management.*	*III-13 to III-18*

ENTITY: *XYZ Agency (XYZ)*

DATE OF FINANCIAL STATEMENTS: *9/30/92*

LINE ITEM: *Accounts Receivable - Net*

ACCOUNT RISK ANALYSIS FORM

FILE: _____

PREPARER_____

REGION _____

DATE _____ Page ___ of ___

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent Risks & Control Environment Weaknesses	Cycle/ Accounting Application	Effective-ness of Control Techniques	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
		Rights and Obligations: *XYZ does not own unencumbered rights to recorded accounts receivable.*	*No significant inherent risk or control environment weaknesses noted.*	*Accounts Receivable*	*Effective*	*Low*	*Low*	*F*	*Identify accounts receivable from related parties or major debtors. Review confirmations for indication of guarantees or encumbrances.*	*III-19 to III-22*

ENTITY: *XYZ Agency (XYZ)*

DATE OF FINANCIAL STATEMENTS: *9/30/92*

LINE ITEM: *Accounts Receivable - Net*

ACCOUNT RISK ANALYSIS FORM

FILE: _____

PREPARER_____

REGION _____

DATE _____ Page ___ of ___

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent Risks & Control Environment Weaknesses	Cycle/ Accounting Application	Effective-ness of Control Techniques	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
Line Item Total	*$876,000,000*	***Presentation and Disclosure:*** *Accounts receivable are not properly classified or disclosed in the financial statements, or based on a consistent application of accounting principles.*	*No significant inherent risk or control environment weaknesses noted.*	*Accounts Receivable*	*Effective*	*Low*	*Low*	*F*	*Determine appropriateness of footnote disclosures. Summarize and test credit risk disclosures. Review accounting principles used.*	*III-23 to III-25, IV-16*

SECTION 400

Testing Phase

Figure 400.1: Methodology Overview

Planning Phase	Section
· Understand the entity's operations	220
· Perform preliminary analytical procedures	225
· Determine planning, design, and test materiality	230
· Identify significant line items, accounts and assertions	235
· Identify significant cycles and accounting applications	240
· Identify significant provisions of laws and regulations	245
· Identify relevant budget restrictions	250
· Assess inherent risk and the control environment	260
· Determine likelihood of effective EDP-related controls	270
· Identify relevant operations controls to evaluate and test	275
· Plan other audit procedures	280
· Plan locations to visit	285

Internal Control Phase	Section
· Understand internal control systems	320
· Identify control objectives	330
· Identify and understand relevant control techniques	340
· Determine the nature, timing, and extent of control tests	350
· Perform nonsampling control tests	360
· Assess controls on a preliminary basis	370

Testing Phase	Section
· Consider the nature, timing, and extent of tests	420
· Design efficient tests	430
· Perform tests and evaluate results	440
·· Sampling control tests	450
·· Compliance tests	460
·· Substantive tests	470
··· Substantive analytical procedures	475
··· Substantive detail tests	480

Reporting Phase	Section
· Perform overall analytical procedures	520
· Determine adequacy of audit procedures and audit scope	530
· Evaluate misstatements	540
· Conclude other audit procedures:	550
·· Inquire of attorneys	
·· Consider subsequent events	
·· Obtain management representations	
·· Consider related party transactions	
· Determine conformity with the entity's accounting principles	560
· Determine compliance with GAO Financial Audit Manual	570
· Draft reports	580

410 - OVERVIEW

.01 During the testing phase, the auditor gathers evidence to report on the Annual Financial Statement, management's assertion about the effectiveness of internal controls, and the entity's compliance with significant provisions of laws and regulations. (See figure 400.1). The following types of tests are performed:

- **Sampling control tests** may be performed to obtain evidence about the achievement of specific control objectives. If the auditor obtains the necessary assurance regarding control objectives through the use of nonsampling control tests, sampling control tests are not necessary, as discussed in section 350. Further guidance on sampling control tests begins in section 450.

- **Compliance tests** are performed to obtain evidence about compliance with significant provisions of laws and regulations. Further guidance on compliance tests is in section 460.

- **Substantive tests** are performed to obtain evidence that provides reasonable assurance of whether the principal statements, and related assertions, are free of material misstatement. Further guidance on substantive tests is in section 470.

.02 During this phase, the auditor performs the following activities for each type of test:

- Consider the nature, timing, and extent of tests
- Design efficient tests
- Perform tests
- Evaluate results

Each of these processes is discussed below in general terms. Specific guidance on each of the processes is provided in the sections referenced above for each type of test.

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420 - CONSIDER THE NATURE, TIMING, AND EXTENT OF TESTS

CONSIDER THE NATURE OF TESTS

.01 The auditor determines the testing methods that will best achieve the audit objectives for sampling control tests, compliance tests, and substantive tests. Testing methods generally can be classified as either analytical procedures or detail tests. Analytical procedures involve the comparison of the recorded test amount with the auditor's expectation of the recorded amount and the investigation of any significant differences between these amounts. Detail tests can be classified in two general categories: sampling and nonsampling. Sampling methods involve the selection of individual items from a population with the objective of reaching a conclusion on all the items in the population (including those not selected for testing). Nonsampling methods involve selections to reach a conclusion only on the items tested. Nonsampling requires the auditor to assess the risk of misstatement in the items not tested.

.02 The testing method selected by the auditor is a matter of the auditor's judgment, considering the objectives of the test, the nature of the population, the results of procedures performed during the planning and internal control phases, (including combined risk assessment and test materiality), and possible efficiencies. For tests that involve sampling, efficiencies can be achieved by using a common sample for each test. These potential efficiencies are discussed further in section 430.

CONSIDER THE TIMING OF TESTS

.03 As discussed in section 295 D, the auditor may choose to conduct tests before or after the balance sheet date (interim testing) or to conduct all tests as of the balance sheet date. Section 495 C provides guidance on interim testing, tests of the period between the interim date and the balance sheet date (the rollforward period), and related documentation.

CONSIDER THE EXTENT OF TESTS

.04 For each type of test, the auditor must determine, based on judgment, the extent of tests to be performed. Generally, the extent of sampling control tests is a function of the auditor's preliminary assessment of the effectiveness of controls and the number of control deviations expected. The

extent of compliance tests is a function of the effectiveness of compliance controls. The extent of substantive tests is a function of combined risk and test materiality.

CONSIDER THE NEED TO SUBSTANTIVELY TEST BUDGET ACCOUNTS

.05 To opine on the statements of budgetary resources and financing, the auditor should have reasonable assurance that the statements present fairly, in all material respects, budgetary resources and the reconciliation of net costs to budgetary obligations of the entity for the period audited. If amounts recorded in the proprietary accounting system can be audited, and reconciling items between the principal statement expenses (based on the proprietary accounting system) and expenditures reported by the budget system tested, direct substantive testing of expenditures is not required. If an entity has budget accounting records but does not maintain separate proprietary accounting records, the auditor should directly test expenditures produced by the budget system and the items necessary to reconcile the budget to the proprietary accounts. Proprietary accounting records are those which support amounts in the principal statements.

.06 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 accumulation of budget amounts (see paragraphs 460.03-.05). In such instances, testing of budgetary expenditures and proprietary expenses frequently can and should be coordinated because of the interrelationships between them. An example of coordination of these procedures is included in section 495 B. Because obligations are not recorded in the proprietary accounts and are not part of the reconciliation of budget expenditures to proprietary expenses, testing obligations for potential misstatements typically cannot be coordinated with audit procedures related to the proprietary accounts.

430 - DESIGN EFFICIENT TESTS

.01 After considering the general nature, timing, and extent of the tests to be performed, the auditor should design specific tests. The auditor should coordinate similar tests to maximize efficiency. For tests that involve sampling, efficiencies can be realized by performing numerous tests on a common sample (multi-purpose testing). The auditor should try to 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 As discussed beginning in paragraph 480.10, there are several methods of selecting a representative sample. When determining the selection method to use during a multi-purpose test, the auditor generally should use the representative sampling method considered most appropriate for substantive detail tests in the particular situation. Use of this selection method is usually the most effective and efficient because sampling control and compliance tests generally can be based on any type of representative sample.

.03 For example, the auditor might 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 and if the test of financial reporting controls would require 45 sample items, the auditor should select 135 items in the sample but test controls relating only to 45. The 45 items for control testing should be selected randomly or systematically (with a random start) from the 135 sample items. For example, beginning from a random start, every third item selected for substantive testing should be tested for controls. If cost effective, the auditor may elect to test controls relating to all sample items to provide additional assurance concerning controls.

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440 - PERFORM TESTS AND EVALUATE RESULTS

.01 The auditor should perform the planned tests and should evaluate the results of each type of test separately, without respect to whether the items were chosen as part of a multi-purpose test. Guidance on performing and evaluating the results is presented for each type of test in the following sections

- Section 450 - Sampling control tests,
- Section 460 - Compliance tests, and
- Section 470 - Substantive tests.

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450 - SAMPLING CONTROL TESTS

.01 Controls that leave documentary evidence of their existence and application may be tested by inspecting this evidence. If sufficient evidence cannot be obtained through such inspections during walkthroughs (in combination with other observation and inquiry tests), the auditor generally should obtain more evidence by inspecting individual items selected using sampling procedures. If multi-purpose testing is impractical or inappropriate, the auditor generally should use random attribute sampling (described beginning in paragraph 450.05) to select items for sampling control tests.

.02 When planning sampling control tests, the auditor should determine (1) the objectives of the test (including what constitutes a deviation), (2) the population of sample items, (3) the method of selecting the sample, and (4) the sample size. The auditor should document the sampling plan in the workpapers.

OBJECTIVES OF THE TEST

.03 The auditor should clearly indicate the objectives of the specific control test. In designing samples for control tests, the auditor ordinarily should plan to evaluate operating effectiveness in terms of the rate of deviations to prescribed controls. This involves defining (1) the specific control to be tested and (2) the deviation conditions. The auditor should define control deviations in terms of control techniques not followed. For example, the auditor might define a deviations in cash disbursements as "invoice not approved and initialed by authorized individual."

POPULATION

.04 In defining the population, the auditor should identify the whole set of items from which the sample should be drawn. This includes (1) describing the population, (2) determining the source document or the transaction documents to be tested, and (3) defining the period covered by the test. When multiple locations are involved, the auditor may consider all or several locations as one population for sampling if the controls at each location are components of one overall control system. Before combining locations into one population, the auditor should consider such factors as (1) the extent of uniformity of the controls and their applications at each location, (2) whether significant changes can be made to the controls or

their application at the local level, and (3) the amount and nature of centralized oversight or control over local operations.

METHOD OF SELECTION

.05 The sample used to test controls should be representative of the entire population. If the sample is not a multi-purpose sample, attribute sampling generally should be used to select items for control testing. Attribute sampling requires random selection of sample items without considering the transactions' dollar amount or other special characteristics. IDEA or other equivalent software may be used to make random selections.

SAMPLE SIZE

.06 In designing attribute samples for which inspection is the principal source of evidence of control effectiveness, the auditor should determine the objectives of the sample. For financial reporting control tests, the objective is to support the preliminary assessment of control risk as either moderate or low. For budget, compliance, and operations control tests, the objective is to support the preliminary assessment of the control as effective. Additionally, for financial reporting, budget, and compliance control tests, there is an objective of obtaining evidence to support the auditor's opinion on management's assertion about the effectiveness of internal controls. Table I on the following page should be used to determine the sample sizes necessary to support these preliminary assessments of controls and to conclude on the effectiveness of the controls. Tables I and II are used to evaluate the test results.

.07 Tables I and II are based on a 90 percent confidence level. This confidence level should be used for all sampling control tests. (This confidence level is appropriate because the auditor obtains additional satisfaction regarding controls through other tests such as substantive tests, inquiry, observation, and walkthroughs.)

.08 Tables I and II are each based on different tolerable rates. The tolerable rate is the maximum rate of deviations from the prescribed control that the auditor would be willing to accept without altering the preliminary assessment of control effectiveness. Table I is based on a tolerable rate of 5 percent, and Table II is based on a tolerable rate of 10 percent. Each table shows various sample sizes and the maximum number of deviations which may be detected in each sample. (See paragraph 450.12 for a discussion of the evaluation of test results.)

Sample Sizes and Acceptable Numbers of Deviations
(90% Confidence Level)

TABLE I
(Tolerable rate of 5%)

(Use for sample selection in all cases)

Sample Size	Acceptable Number of Deviations
45	0
78	1
105	2
132	3
158	4
209	6

TABLE II
(Tolerable rate of 10%)

(Use for evaluation only if preliminary assessment of financial reporting control risk is low and deviations exceed Table I)

Sample Size	Acceptable Number of Deviations
45	1
78	4
105	6
132	8
158	10
209	14

.09 For financial reporting controls, if the preliminary assessment of control risk is low or moderate, Table I should be used to determine sample size. (OMB Bulletin 93-06 no longer allows the auditor to test controls at the moderate level (do less control testing for efficiency and more extensive substantive procedures) if the control risk is preliminarily assessed as low. That is, OMB requires the auditor to perform sufficient control tests to justify a low assessed level of control risk, if controls have been properly designed and placed in operation.)

.10 For budget, compliance, and operations controls, sample sizes should also be determined using Table I.

.11 The auditor generally should use the sample size indicated for 0 acceptable deviations (45 items for Table I). Use of these sample sizes typically will be the most efficient for assessing control effectiveness and will be sufficient to support the report on internal controls. However, the auditor may select larger sample sizes if control deviations are expected to occur but not exceed the acceptable number of deviations for the table.

EVALUATING TEST RESULTS

Financial Reporting Controls

.12 If deviations are noted that exceed the acceptable number for the sample size, the auditor must 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, control risk may be assessed as moderate. For example, if the original sample was 45 items, the auditor may reduce the assessment of control risk to a moderate level if there is not more than 1 deviation. If the auditor finds more than 1 deviation with a sample size of 45 items, the auditor must conclude that the controls being tested are not operating effectively and must reassess control risk as high.

- **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 (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.

Budget Controls

.13 If deviations are noted that exceed the acceptable numbers for the sample sizes shown in Table I, the auditor should conclude that the budget control is not effective. The auditor also should determine whether any deviations noted ultimately resulted in noncompliance with a budget related law or regulation.

Compliance Controls

.14 If deviations are noted that exceed the acceptable number for the sample sizes shown in Table I, the auditor should conclude that the compliance control is not effective. The auditor should determine whether any deviations noted ultimately resulted in noncompliance.

Operations Controls

.15 If deviations are noted that exceed the acceptable number for the sample sizes shown Table I, the auditor should conclude that the operations control is not effective. The auditor should not place reliance on ineffective operations controls when performing other auditing procedures.

OTHER CONSIDERATIONS

.16 If, during the testing of sample items, the number of deviations exceeds 20% of the number of items in the sample (for example, 10 deviations out of a sample size of 45 items), the auditor should consult with audit team management before completing the testing of the sample. Audit team management should determine whether additional information is needed to report control weaknesses as described in paragraphs 580.31-.57. The significance of the weakness will determine how the auditor reports the finding and, therefore, which elements of the finding (condition, cause, criteria, possible effect, and recommendation or suggestion) need to be developed.

.17 If an unacceptable number of deviations are noted in the original sample and the auditor believes the use of a larger sample size might result in an acceptable number of deviations, the auditor should not select additional sample items without consulting with the Director of Planning and Reporting or designee. The selection of additional sample items cannot be based on Tables I or II.

.18 The auditor should consult with the Director of Planning and Reporting or designee if projecting the rate of sample control deviations to a population for disclosure in a report. While typically stated as a percentage of transactions, the deviation rate is expressed as a percentage of dollars in the population if sampling control tests are performed on a sample selected using DUS (see paragraphs 480.14-.23).

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460 - COMPLIANCE TESTS

.01 The type of provision of a law or regulation and the assessment of the effectiveness of compliance controls affect the nature and extent of compliance testing. Based on the type of provision (as discussed in paragraph 245.01) the compliance tests discussed below should be performed.

TRANSACTION-BASED PROVISIONS

.02 To test transaction-based provisions, the auditor should use representative sampling to select specific transactions for testing compliance. The selection of transactions to test may be combined with tests of financial reporting, budget, operations, or compliance controls and/or with substantive tests, as appropriate. If the selection is solely for compliance testing, the auditor generally should use a random attribute sample (see paragraph 450.05). The following minimum sample sizes (on an entitywide basis) should be used to test compliance with transaction-based provisions, depending on the effectiveness of compliance controls:

Compliance Controls	Confidence Level	Minimum Sample Size
Effective	80	32
Not Effective	95	59

Evaluation of test results is discussed in paragraph 460.07. The auditor should test the entire sample, even if exceptions (instances of noncompliance) are detected. If compliance controls were assessed on a preliminary basis as effective and the results of testing indicated that this assessment is not appropriate, the auditor should increase the sample size from 32 to 65 by randomly selecting 33 additional items.

QUANTITATIVE-BASED PROVISIONS

.03 Generally, effective compliance controls should provide reasonable assurance that the accumulation/summarization of information is accurate and complete. If the compliance controls do not provide such reasonable assurance, the auditor should test the accumulation of information directly for existence, completeness, and summarization. Such tests may be either

sampling or nonsampling in nature and generally should be designed to detect misstatements that exceed 5% of the total amount of the summarized information or the amount of the restriction stated in the provision, if any. (The amount of the restriction is described in paragraph 245.01.) Such tests may be discontinued if significant misstatements are noted that would preclude compliance. The test for compliance is the comparison of the accumulated/summarized information with any restrictions the amounts stated in the identified provision.

.04 For example, if provisions of budget-related laws and regulations are considered significant and if related budget and consequently compliance controls are ineffective, the auditor should test the summarized information directly for the following potential misstatements in budget execution information:

- **Validity:** Recorded amounts are not valid. (See section 395 F for validity criteria for obligations and expenditures.)

- **Completeness:** Not all amounts are recorded.

- **Cutoff:** Obligations and expenditures are not recorded in the proper period.

- **Recording:** Obligations and expenditures are not recorded at the proper amount.

- **Classification:** Expenditures and obligations 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 section 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 section 495 B. Audit procedures for testing budget execution information should be designed to detect misstatements using a test materiality calculated as 5% of total budget authority. For example, if using DUS sampling (described beginning in paragraph 480.14), the auditor should use

a maximum sampling interval equal to 1 and two-thirds percent of total budget authority (5% of budget authority divided by a statistical factor of 3.0).

PROCEDURAL-BASED PROVISIONS

.06 In testing compliance controls relating to a procedural-based provision, the auditor generally would obtain sufficient evidence to conclude whether the entity performed the procedure and therefore complied with the provision. For example, the auditor's tests of compliance controls concerning receipt of information from grantees generally would provide evidence of whether such information was received and therefore whether the entity complied. If compliance control tests do not provide sufficient evidence to determine compliance, the auditor should perform additional procedures, as considered necessary, to obtain such evidence.

EVALUATING TEST RESULTS

.07 For any possible instances of noncompliance noted in connection with the procedures described above or other audit procedures, the auditor should

- discuss such possible instances with OGC and, when appropriate, OSI and conclude whether noncompliance has occurred and the implications of such noncompliance;

- identify the weakness in compliance controls that allowed the noncompliance to occur, if not previously identified during compliance control testing;

- report the nature of any weakness in compliance controls and consider modification of the opinion on internal controls as appropriate. (See paragraphs 580.31-.55);

- consider the implications of any instances of noncompliance on the financial statements; and

- report instances of noncompliance, as appropriate. (See paragraphs 580.56-.66.)

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470 - SUBSTANTIVE TESTS - OVERVIEW

.01 In the internal control phase, the auditor preliminarily assesses the level of combined (inherent and control) risk for each significant assertion within each significant line item or account (see section 370). Substantive audit procedures should be applied to all significant assertions in significant principal statement line items and accounts. The auditor's objective during substantive tests is to determine whether the assertions are materially misstated and to form an opinion about whether the principal statements are presented fairly in accordance with the entity's basis of accounting. To determine if significant assertions are misstated, the auditor should consider designing substantive tests to detect each of the potential misstatements in assertions that were developed in the internal control phase (see section 330). Additionally, the auditor should consider whether efficiencies can be achieved by using the concepts of directional testing, as discussed beginning in paragraphs 470.14-.16.

.02 Based on expected overall audit assurance of 95% on AFMD audits (as discussed in section 260), the following minimum levels of substantive assurance for each level of combined risk are considered to be appropriate:

Low combined risk	63%
Moderate combined risk	86%
High combined risk	95%

Substantive assurance is a measure of the auditor's confidence that a substantive test will detect any material misstatements. Substantive assurance correlates directly with the level of combined risk. The higher the risk, the more substantive assurance required.

TYPES OF SUBSTANTIVE TESTS

.03 There are two general types of substantive tests: (1) substantive analytical procedures and (2) tests of details. To achieve the required substantive assurance (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, within the framework of the audit matrix (discussed in paragraph 470.10), is a matter of the auditor's judgment and should be based on effectiveness and efficiency considerations.

Substantive analytical procedures

.04 Substantive analytical procedures involve the comparison of a recorded amount with the auditor's expectation of that amount and investigation of any significant differences to reach a conclusion on the recorded amount.

.05 Substantive analytical procedures may be performed at one of three levels for an assertion, as follows:

- **Complete:** The auditor relies solely on analytical procedures for all of the assurance required from substantive procedures. The procedure must be so persuasive that the auditor believes that it will detect any aggregate misstatements that exceed test materiality.

- **Partial:** The auditor relies on a combination of analytical procedures and tests of details to obtain an appropriate level of substantive assurance. For partial assurance, the auditor believes that the analytical procedures should detect any aggregate misstatements that exceed test materiality.

- **None:** The auditor does not rely on analytical procedures for substantive assurance. All substantive assurance will be obtained from tests of details. In this situation, supplemental analytical procedures may be performed to increase the auditor's understanding of account balances and transactions, but not to provide any additional substantive assurance. These procedures are similar in scope to those performed on an overall basis at the financial statement level (see section 520).

.06 To determine whether to perform complete or partial substantive analytical procedures, the auditor should consider the effectiveness or persuasiveness and efficiency of such procedures. In so doing, the auditor should consider the factors discussed in detail in section 495 A.

Detail tests

.07 Detail tests are test procedures that are applied to individual items selected for testing and include:

- **Confirmation** consists of obtaining and evaluating direct communication from a third party concerning a balance or transaction or the related terms, such as cash in treasury, accounts receivable, or accounts payable.

- **Physical observation** includes inspecting or counting tangible assets, such as inventory or property, plant, and equipment, and applying related procedures.

- **Vouching** consists of examining supporting documents to determine whether a balance is properly stated. For example, the auditor might examine invoices for property and equipment purchases.

- **Recalculation** includes checking mathematical accuracy of entity records by footing or crossfooting or by recomputing amounts and tracing journal postings, subsidiary ledger balances, and other details to corresponding general ledger accounts. For example, the auditor might 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.

.08 Detail tests are generally used in combination to provide sufficient substantive assurance about an assertion. For example, to test the valuation of accounts receivable, the auditor might confirm balances, recalculate the aging schedule, vouch documents supporting the aging and specific delinquent accounts, and discuss collectibility with management. On the other hand, a single detail test procedure might provide substantive assurance about more than one of the five financial statement assertions. For example, a confirmation of cash in Treasury might provide evidence about existence, valuation, rights, and presentation and disclosure.

.09 The minimum extent of detail testing to be performed is based on the combined risk assessment and the amount of assurance obtained from substantive analytical procedures, as illustrated in the Audit Matrix (figure 470.1).

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DETERMINING MIX OF SUBSTANTIVE TESTS

.10 In determining an appropriate mix of analytical procedures and detail tests, the auditor should consider the following matrix (figure 470.1) which illustrates the integration of such tests for each level of combined risk.

Figure 470.1: Audit Matrix

Assessed combined risk level	Sub-stantive assurance	Sub-stantive assurance from analytical procedures [a]	Minimum substantive assurance from detail tests
Low	63%	Complete	0%
		Partial	50%
		None	63%
Moderate	86%	Complete	0%
		Partial	77%
		None	86%
High	95%	Complete	0%
		Partial	92%
		None	95%

[a] Complete assurance from 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 combined risk is assessed as high. Therefore, complete reliance on analytical procedures for substantive assurance in these situations is rare, particularly for balance sheet accounts.

.11 Additional factors to consider in determining an appropriate mix of analytical procedures and detail tests include the following:

- **The nature and significance of the assertion being tested:** Analytical procedures are generally more likely to be effective for assertions related to income statement accounts than for those related to balance sheet accounts. Significant assertions generally require more or higher quality audit evidence which may not be available from analytical procedures.

- **The nature of the combined risk:** Substantive tests should be designed to address the specific type and level of combined risk for each assertion. For example, for certain loss claim liabilities, detail tests might be used to search subsequent claim payments for potential liabilities in testing the completeness assertion, while analytical procedures might be applied to test the related valuation assertion by evaluating the amounts per claim.

- **The availability of different types of evidence:** Using evidence that can be readily obtained might be more efficient. For example, in federal government audits, the availability of budgets and other information might assist in performing analytical procedures.

- **The quality of the respective types of evidence available:** The higher the quality of a type of evidence, the greater the level of assurance that the auditor may derive from that type (see paragraph 470.13).

- **The anticipated effectiveness of analytical procedures:** Detail tests should be used if analytical procedures are not expected to be effective.

.12 When determining the types of substantive tests to use, the auditor's goal should be to choose the mix of effective procedures that are considered to be the most efficient in combination with sampling control tests and compliance tests. The auditor should exercise judgment when assessing the effectiveness or persuasiveness of all audit procedures, particularly analytical procedures.

.13 When considering a procedure's relative effectiveness, the auditor is concerned about the expected quality of the evidence. The quality of evidence obtained in a substantive test depends highly on the

circumstances under which it is obtained and should be evaluated with skepticism. The following are generalizations about evidence:

- Evidence obtained from independent third parties provides a higher level of assurance than that 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 that 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 that obtained before or after the balance sheet date, as the audit risk generally increases with the length of the intervening period.

- The lower the control risk associated with an entity's internal controls, the higher the assurance concerning the information generated within that structure.

DIRECTIONAL TESTING

.14 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, a substantive test of accrued payroll should detect misstatements in both accrued payroll and payroll expense. In designing substantive tests, after considering combined risk and developing an understanding of each related account, the auditor should consider the effect of such tests on related accounts. For example, a test of sales for completeness may provide substantive evidence on the completeness of accounts receivable. In many instances where double-entry accounting is used, it might be efficient to (1) design an overall 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 might 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.

.15 In some instances, the auditor may need to supplement a directional testing approach to address specific combined risks. For example, if inherent and control risk factors warrant, the auditor might test both existence and completeness 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.

.16 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.

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475 - SUBSTANTIVE ANALYTICAL PROCEDURES

.01 This section provides guidance on the application of substantive analytical procedures. Analytical procedures are sometimes referred to as fluctuation analysis, flux analysis, predictive tests, or analytical review. These procedures consist of comparing recorded account balances with the auditor's expectations. The auditor develops an expectation or estimate of what the recorded amount should be based on an analysis and understanding of relationships between the recorded amounts and other data. This estimate 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 continue unless conditions are known that would change the relationship.

.02 Scanning account detail and recomputation are two other audit procedures related to analytical procedures. Scanning consists of searching for unusual items in the detail of account balances. Scanning is an appropriate tool to investigate the cause of a significant fluctuation, but it is not considered a substantive analytical procedure on its own. Unusual items identified through scanning should be investigated to obtain substantive assurance about the unusual items. The auditor may 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 to be 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.

.03 The risk of forming the incorrect conclusion on the account balance tested is higher for substantive analytical procedures than for detail tests because of the procedures' extensive use of the auditor's judgment. Accordingly, quality control is of critical importance. To help maintain a high level of quality in these procedures, the assessment of the amount of reliance to place on the procedures, the design of the procedures, and the formulation of conclusions on the results of these procedures should be performed or closely supervised and reviewed by experienced audit team personnel.

PERFORMING SUBSTANTIVE ANALYTICAL PROCEDURES

.04 If substantive analytical procedures are used, the auditor should perform steps a. through l. below:

a. Determine the amount of the limit. The limit is the amount of difference between the expectation and the recorded amount that the auditor will accept without investigation. The determination of the limit is a matter of the auditor's judgment, based on the guidelines provided in paragraphs 475.05. The guidelines consider the amount of substantive assurance desired from analytical procedures.

b. Identify a plausible, predictable relationship, and develop a model to calculate an expectation of the recorded amount.

c. Gather data for developing the expectation, and perform appropriate procedures to establish the reliability of the data. The reliability of these base data is subject to the auditor's judgment. The reliability of data is discussed further in section 495 A.

d. Develop the expectation of the recorded amount using the information obtained during the previous steps. The preciseness of the expectation is subject to the auditor's judgment and is discussed further in section 495 A.

e. Compare the expectation with the recorded amount, and note the difference.

f. Obtain explanations for differences that exceed the limit, since such differences are considered significant.

g. Corroborate explanations for significant differences.

h. Determine whether the explanations and corroborating evidence provide sufficient evidence for the desired level of substantive assurance. If unable to obtain a sufficient level of substantive assurance from analytical procedures, perform additional procedures as discussed in paragraphs 475.12-.17 and consider whether the difference represents a misstatement.

i. Consider whether the assessment of combined risk remains appropriate, particularly in light of any misstatements identified. Revise the

assessment of combined risk, if necessary, and consider the effects on the extent of detail tests.

j. Document (on the Summary of Possible Adjustments as discussed in 540.04) 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 considered a known or likely misstatement and is not posted to the Summary of Possible Adjustments.

k. Conclude on the fair presentation of the recorded amount.

l. Include documentation of work performed, results, and conclusions in the workpapers. Required documentation is discussed in section 490.

GUIDELINES FOR ESTABLISHMENT OF 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 following guidelines should be followed to establish the limit for each level of reliance on analytical procedures for substantive assurance:

- **Complete reliance:** The limit should not exceed 20 percent of test materiality.

- **Partial reliance:** The limit should not exceed 30 percent of test materiality.

- **No reliance:** Substantive analytical procedures are not used.

INVESTIGATION OF SIGNIFICANT DIFFERENCES

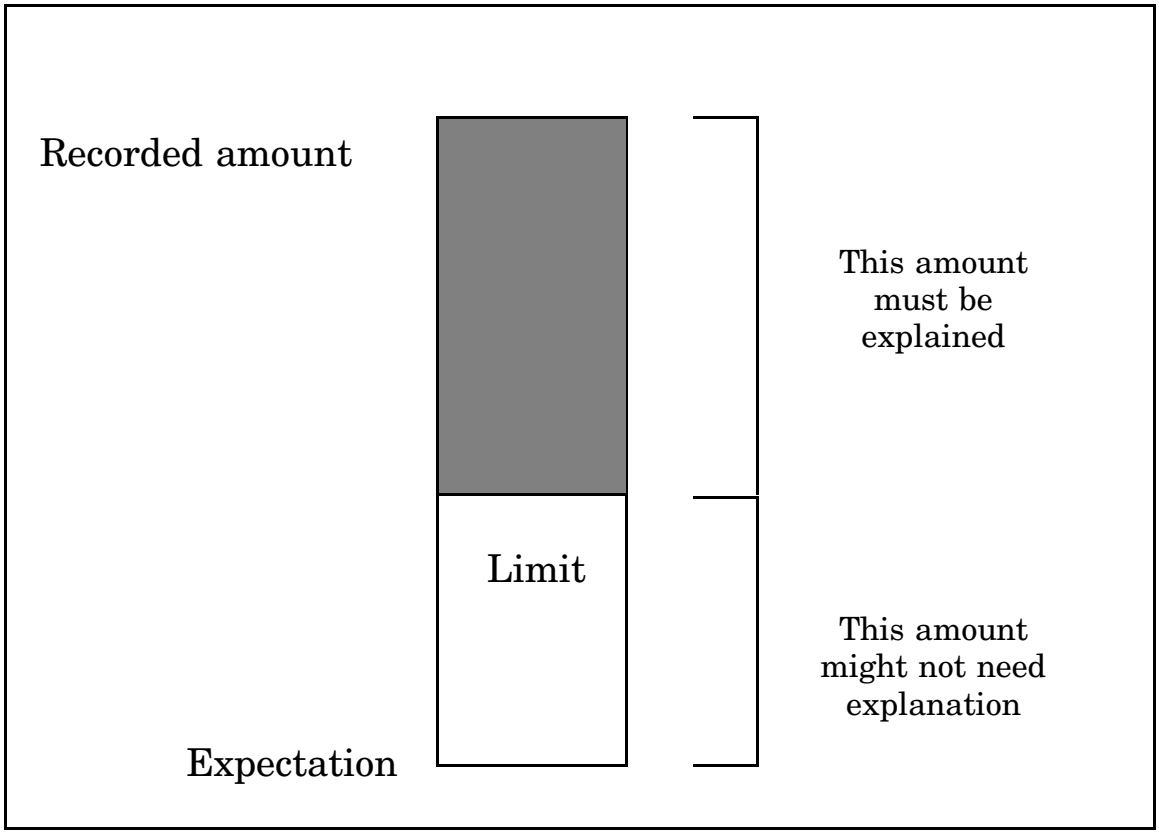
Causes of significant differences

.06 Differences between the expectation and the recorded amount typically 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.

Amount of Difference to Be Explained

.07 When obtaining explanations, it is usually helpful to review with entity personnel the model and assumptions used to develop the expectation. Entity personnel 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 generally should try to obtain an explanation for the entire difference between the recorded amount and the expectation. The portion of the difference that exceeds the limit must be explained in order to rely on the substantive analytical procedure (see figure 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 may cause the expectation to differ from the actual amount, regardless of whether the factors increase or decrease the difference.

Figure 475.1: Amount of Difference Explained 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 judgment. Corroboration may consist of reviewing supporting documentation or corroborating explanations received from accounting department personnel with personnel from the appropriate operating department. The explanations for the fluctuations should be quantified and should address the direction and magnitude of the event causing the fluctuation. The auditor should be careful to corroborate all explanations received. In determining whether sufficient corroborating evidence has been obtained, the auditor should consider the guidelines for complete and partial assurance discussed in paragraph 470.05.

Example of an adequate explanation for a significant fluctuation

.09 Assume that the auditor determined test materiality to be $25 million. Additionally, assume that the auditor has determined, after considering any inherent and control risks, that a substantive analytical procedure should be performed with a limit of $5 million. The auditor estimated interest expense at $80 million by multiplying the average loan balance of $1 billion by the 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 $94.5 million is higher than the estimated amount by $14.5 million and exceeds the limit by $9.5 million.

.10 An explanation from entity personnel that "we borrowed more money this year and interest rates are higher than last year" would not be adequate. This explanation needs to be quantified and corroborated.

.11 An example of an adequate explanation follows:

> Based on a review of correspondence from lenders, interest rates increased during the year and then fell and were computed to average 9 percent based on a monthly average. Additionally, loan statements from lenders indicate that $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 auditor's original estimate.

Therefore, 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
Total difference explained					$14,500

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 sufficient to provide either complete or partial assurance, the auditor must perform additional substantive procedures. These procedures may consist of

- increasing the effectiveness of the substantive analytical procedures by making the expectation more precise in order to obtain the amount of desired assurance,
- performing tests of details and placing no reliance on the substantive analytical procedures that were ineffective, or
- treating the difference as a misstatement.

.13 The auditor should consider the relative efficiency of each of these options. Deciding whether to perform additional substantive procedures is a matter of the auditor's judgment. The additional procedures must provide the auditor with adequate assurance that aggregate misstatements that exceed test materiality have been identified.

.14 To increase the persuasiveness or effectiveness of an analytical procedure, the auditor generally needs to make the expectation more precise. The auditor can do so by

- building a more sophisticated model by identifying more key factors and relationships,
- disaggregating the data (such as using monthly instead of annual data), or

- using more reliable data or obtaining greater confidence in the data's reliability by corroborating the data to a greater extent.

Measuring the preciseness of the expectation and the impact of changing each of these factors on the procedure's effectiveness is difficult and is left to the auditor's judgment.

.15 If detail tests are used to test the account balance because adequate explanations cannot be obtained or corroborated, the auditor still must obtain an overall understanding of the current-year financial statements when applying the required overall analytical procedures at the financial statement level. As discussed in section 520, significantly less work is needed to obtain this overall understanding of the financial statements than when using analytical procedures as a substantive test.

.16 Additionally, if analytical procedures originally performed as a substantive test do not provide the required amount of assurance, the auditor may be able to use those procedures to supplement an understanding of the account balances or transactions after obtaining substantive assurance is through detail tests.

.17 When the auditor places no reliance on substantive analytical procedures, all substantive assurance is provided by detail tests. In this situation, less rigorous, supplemental analytical procedures may be used 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 judgment to determine which fluctuations to explain.

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480 - SUBSTANTIVE DETAIL TESTS

POPULATION TO BE TESTED

.01 In designing detail tests, the assertion tested affects 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 (1) selecting items from those that comprise the account balance and (2) then testing those items to evaluate whether such inclusion in the account balance is proper. For example, to test an expense account for existence, the auditor might select individual expense amounts included in the balance from a detail general ledger 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 The test population should agree with or be reconciled to the recorded amount of the account balance being tested. The auditor should test reconciling items, if any, in an appropriate manner.

.03 Conversely, the completeness assertion deals with whether all transactions and accounts that should be presented in the financial statements are so included. To detail test the completeness assertion, the auditor should select from an independent population of items that should be recorded in the account. The auditor should (1) select items that should be recorded and (2) determine whether they are included in the recorded balance. For example, the auditor might select items from a shipping log, trace them to recorded sales amounts, and then test the summarization of those amounts to inclusion in the general ledger sales balance.

SELECTION METHODS FOR DETAIL TESTS

.04 Detail tests of a population may be applied to any of the following:

- all items comprising the population;
- a representative sample of items comprising the population; or

- a nonrepresentative selection of items that have one or more relevant characteristics, such as those that are large in amount, provided that other substantive tests are applied to the remaining items unless they are immaterial in total.

.05 Detail-testing of **all items comprising 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 comprise an entire balance.

.06 Detail testing of **a representative sample of items comprising the population** is generally most appropriate for accounts consisting of a large number of items, especially if those items are relatively homogeneous or can be stratified into relatively homogeneous groups. The auditor selects sample items in such a way that the sample and its results are expected to be representative of the population. Each item in the population must have an opportunity to be selected, and the results of the procedures performed can be projected to the entire population. Paragraphs 480.08-.41 provide additional information on sampling.

.07 Detail tests of **a nonrepresentative selection of items that have one or more relevant characteristics** may be appropriate for populations consisting of large numbers of items, only some of which have the relevant characteristic. While the size of amount is frequently the characteristic, other relevant characteristics might include an unusual nature or amount, 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 date for cutoff testing). The effects of any misstatements found should be evaluated; however, unlike representative sampling the results of procedures applied to items selected under this method <u>may not be projected to the items not tested</u>. Accordingly, the auditor must apply appropriate analytical and/or other substantive procedures to the remaining items, unless those items are immaterial in total.

REPRESENTATIVE SAMPLING

.08 Sampling requires the exercise of professional judgment as well as an adequate knowledge of statistical sampling methods. The following paragraphs provide a framework for applying sampling to financial audit situations, but are not meant to be a comprehensive discussion. The auditor should consider whether he or she may need to consult with the

Director of Planning and Reporting or designee or other sources for assistance in designing and evaluating samples. The auditor should consider the costs and benefits in determining which type of representative sampling to use. The following paragraphs provide an overview of sampling, primarily with respect to the existence assertion. Similar concepts and methods apply to the completeness assertion, except that the population for selection differs. (See paragraphs 480.01-.03.)

.09 In representative sampling, the sample must be selected from all the items that comprise the population so that each item has an opportunity for selection. For example, the auditor might select sample items from a list of all accounts receivable balances that is reconciled to the related account balance. Selecting sample items from file drawers is not a valid selection method for any type of sampling unless the auditor has determined that all items comprising the population are included in the drawers.

.10 The number of items selected from the population for testing is a function of the size of the population, the desired amount of substantive assurance from detail tests (as shown on the audit matrix), and the sample selection method. The following methods of representative sample selection are available:

- dollar-unit sampling (DUS),
- DUS-approximation sampling,
- classical variables estimation sampling, and
- other sampling methods.

.11 The choice of the representative sample selection method to be used is a matter of the auditor's judgment. When making this decision, the auditor should consider whether the dollar amounts of the individual items comprising the population are available (such as on a detail listing or a computer file), the expected amount of misstatements, and the relative cost and efficiency of each appropriate sampling method.

.12 If the dollar amounts of the individual items comprising the population are known, the auditor should use either DUS, classical variables estimation sampling, or DUS-approximation sampling. If dollar amounts of these individual items are not known, the auditor generally should use other representative sampling methods; in certain circumstances, classical variables sampling may be used.

.13 Additional background and guidance on sampling is provided in the audit guide Audit Sampling, published by the American Institute of Certified Public Accountants and in Using Statistical Sampling published by GAO (accession number 129810).

SAMPLE SELECTION

Dollar-unit sampling (DUS)

.14 Dollar-unit sampling (DUS) is a type of representative sampling that the auditor should consider using when:

a. the dollar amounts of individual items in the population are known, and

b. the auditor expects that a relatively small amount of misstatement exists in the population.[1]

c. The amount of misstatements in an individual item cannot exceed the recorded balance.

DUS is also known as probability proportional to size and monetary unit sampling.

.15 In a manually applied DUS, a sampling interval (n) is used to select every nth dollar from the dollars in the individual items that comprise the population. These items might be recorded amounts for individual receivable balances, inventory items, invoices, or payroll expenses. The item that contains the nth dollar is selected for testing. DUS is representative of all dollars in the population; however, larger items have a higher probability of selection (for example, a $2,000 item has approximately twenty times greater probability of selection than a $100 item).

.16 When a relatively small amount of misstatement exists in the population,[1] DUS will yield the smallest sample size for a given population, test materiality, and desired level of substantive assurance when all representative sampling methods are considered. When the auditor expects

[1] There is no generally accepted definition of a "relatively small amount of misstatement." For two commonly used classical variables sampling methods, many statisticians suggest a need for at least 20 individual differences in the sample.

that the population contains more than a relatively small amount of misstatement, he or she should consider using classical variables sampling (see 480.28).

.17 In DUS, sample size is determined by the dollar amount of the population, test materiality, and required level of substantive assurance. As discussed in paragraph 230.13, test materiality includes a consideration of the significant misstatements that might exist in the population. The Director of Planning and Reporting or designee (or use of IDEA) can help in adjusting test materiality for such misstatements. The auditor should use the statistical risk factors in figure 480.1 to determine sample sizes for each level of substantive assurance.

Figure 480.1: Statistical Risk Factors

Level of Assurance	Statistical Risk Factor
50%	0.7
63%	1.0
77%	1.5
86%	2.0
92%	2.5
95%	3.0

Section 495 D contains the audit matrix with the appropriate risk factor for each level of combined risk and reliance on substantive analytical procedures.

.18 The statistical risk factors are used in the following formulas to determine the sampling interval and sample size for DUS:

1. sampling interval = test materiality ÷ statistical risk factor

2. sample size = recorded amount ÷ sampling interval

Sample sizes should be stated in whole numbers. Uneven amounts should be rounded up to the next whole number. For example, a sample size of 40.2 items should be rounded up to 41 items.

.19 For example, to test a recorded amount of $30 million with a test materiality of $900,000 and 95% assurance, the statistical risk factor would be 3.0. The sampling interval would be $300,000 (test materiality of $900,000 divided by the statistical risk factor of 3.0). Essentially, from a random start, every 300,000th dollar is selected. Therefore, the preliminary estimate of sample size of 100 items is calculated by dividing the recorded amount of $30 million by the sampling interval of $300,000. Because the amount of certain items might equal or exceed the sampling interval, a selection might include more than 1 sample item (for example, a $600,000 selection would include 2 of the 100 estimated sample items), thereby making the actual number of items tested fewer than 100.

.20 The auditor should consider potential efficiencies in first year audits from initially using a statistical risk factor of 3.0 to select the sample, but testing only the number of items necessary to achieve the planned amount of substantive assurance. The items tested should be spread evenly throughout all of the items selected. For example, if a statistical risk factor of 1.5 is appropriate based on the planned amount of substantive assurance, the auditor would make selections using a statistical risk factor of 3.0, (twice as many selections as the factor of 1.5) and initially test every other selection (beginning with a random start).

.21 If the preliminary assessment of combined risk or reliance on substantive analytical procedures is not supported by the results of testing, the substantive assurance needed from detail tests increases, and the auditor would then test the additional items selected in the initial sample.

.22 If additional sample items are not selected during the initial sample, and the amount of assurance needed from detail tests is revised, the auditor should consult with the Director of Planning and Reporting or designee to determine how to select additional sample items. Selection of these additional items may be more complex and less efficient than if they were chosen during the initial sample. The auditor should consider the relative chance of revision of the amount of planned assurance from detail tests and the incremental costs involved when determining whether to select additional items during the initial sample.

.23 Section 495 F describes how to manually select items using DUS. Computer software, such as IDEA, may also be used to select a DUS sample. The choice of selection method used should be based on efficiency considerations.

DUS-approximation sampling

.24 DUS-approximation sampling is a type of representative sampling the auditor should consider using when the criteria for using DUS are met (see paragraph 480.14), but the relative cost or difficulty of sample selection using DUS is considered too high, and DUS-approximation is expected to be less costly or difficult.

.25 Under DUS-approximation, the auditor first stratifies the population into relatively homogeneous groups based on size. Next, the auditor randomly selects individual items for testing from each stratum. The number of items selected from each stratum is based on the total dollar amount of the stratum and the sampling interval. The preliminary estimate of sample size should exceed that of a DUS sample for the same population by at least 25%. For example, if the sample size for a population using DUS would be 100 items, 125 should be used for DUS-approximation sampling.

.26 When using DUS-approximation sampling, the auditor is trying to achieve the same type of results as if DUS was used (and every *n*th dollar was selected), but in a manner that may be less difficult and costly than using DUS; however, DUS-approximation requires the selection and testing of larger samples than those obtained using DUS. When determining the most efficient sampling method to use, the auditor should consider the relative cost and difficulty of sample selection as well as the relative sample sizes.

.27 A DUS-approximation sample should be selected as follows:

a. Determine the sample size by (1) computing a comparable DUS sample size (100 in the preceding example) and (2) increasing that size by 25% (a preliminary estimate of sample size of 125, using the example above), or more if the auditor believes it is necessary after considering the nature of the combined risk.

b. Compute the implicit sampling interval by dividing the population by the preliminary sample size. (For example, for a population of $30 million and a sample size of 125, the sampling interval is $240,000.) If a computed sampling interval is not a whole number, the amount should be rounded down.

c. If the balance consists of amounts that are not relatively homogeneous, stratify the items comprising the balance into relatively homogeneous

groups based on relative size. For example, items might be stratified into the following strata: (1) items that equal or exceed the amount of the implicit sampling interval (top stratum), (2) relatively significant items (intermediate stratum); and (3) relatively insignificant items (bottom stratum). The following table illustrates how a balance might be stratified:

Figure 480.2: Example Account Balance Stratification

Stratum	Number of items in population	Total balance	Average balance	Preliminary estimate of sample size[a]	Actual number of items tested[b]
Top	10	$19,920,000	$1,992,000	83	10
Inter-mediate	490	9,120,000	18,612	38	38
Bottom	500	960,000	1,420	4	4
Totals	1,000	$30,000,000	$ 30,000	125	52

[a] The preliminary estimate of sample size is computed by dividing the total balance by the implicit sampling interval of $240,000. Uneven amounts are rounded up to the next whole number.

[b] The actual number of items tested in the top stratum might be fewer than the preliminary estimate of sample size because, when the amount of a top stratum item exceeds the implicit sampling interval, a top stratum selection might include more than one sample item. For example, when the implicit sampling interval is $240,000, a $600,000 selection would include 2 or 3 of the sample items.

d. Select all top stratum items for testing, and <u>for each other stratum</u> (1) divide the aggregate size by the implicit sampling interval (rounding up) to determine the number of sample items for the stratum and (2) use a random or systematic (with a random start) sampling methodology (described in paragraph 480.32) to select the required number of items. In the example above, the sample would consist of the 10 top stratum items, 38 ($9 million divided by $240,000) items from the intermediate stratum, and 4 ($1 million divided by $240,000) items from the bottom stratum.

Classical variables estimation sampling

.28 Classical variables estimation sampling is a type of representative sampling that the auditor should consider using when the auditor expects a significant number of misstatements to exist in the population.

.29 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 DUS sampling. Because applying this method is somewhat complex, the auditor should consult with the Director of Planning and Reporting or designee before using it.

Other sampling methods

.30 Other representative sampling methods might be used if the dollar amounts of individual items in the population are not known. The auditor might select individual items to test the attributes of the population. These methods usually have limited application in substantive testing (that emphasizes dollar amounts), except for testing the completeness assertion where the selection is made from a population independent of the population being tested (see paragraphs 480.01-.03). For example, items might be randomly selected from a shipping log to test the completeness assertion for sales.

.31 For this type of test, the number of items to select may be based on the dollar amount of either the population that the auditor is sampling from (if the dollar amount of the total is available) or the dollar amount of the population that the auditor is testing. The preliminary estimate of sample size for this sample should exceed the sample size that would result from using DUS by at least 25%.

.32 Items should be selected using random selection based on random number tables, a computer-based random number generator, through some other method that would result in random selection, or through use of systematic selection (every *n*th item) with a random start. For example, the auditor might begin with a random start and then chose every *n*th item, where *n* is the sampling interval. The sampling interval would be determined by dividing the number of items in the population by the desired number of selections.

.33 To use any selection method for substantive testing that is not described in this section, the auditor should consult with the Director of Planning and Reporting or designee.

EVALUATION OF SAMPLE RESULTS

.34 The effects of any misstatements detected in a representative sample must be projected to the population. In doing so, the auditor should note the cause of any misstatement found and should evaluate whether the misstatement is isolated or representative of the entire population. If the evidence is highly persuasive that a misstatement is isolated (i.e., not representative of the population), the auditor must (1) perform procedures to test that the same type of misstatement does not exist elsewhere in the population, (2) evaluate the isolated misstatement, and (3) evaluate the sample, excluding the isolated misstatement. The projected misstatement amount should be included in the Summary of Possible Adjustments as a likely misstatement, the evaluation of which is discussed in section 540.

.35 The auditor also should consider whether the assessment of combined risk remains appropriate, particularly in light of any misstatements identified. If the combined risk assessment was not appropriate, the auditor should consult with the Director Planning and Reporting or designee to determine whether the extent of substantive procedures is adequate.

.36 When several understated amounts are detected in any sample designed primarily to test for the existence assertion (i.e., designed to test primarily for overstatement), the auditor should consult with the Director of Planning and Reporting or designee in evaluating the sample results.

Evaluating the results of a DUS sample

.37 For a misstatement detected in an item selected manually in a DUS sample (paragraphs 480.14-.23) that 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 as follows: (1) divide the amount of misstatement by the recorded amount of the sample item and (2) multiply 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% misstatement, which results in a projected misstatement of $30,000 (10% of the $300,000 sampling interval). In this case, the aggregate projected misstatement is $80,000. Evaluation of a DUS sample selected using audit software such as IDEA should be performed using the software. For example, DUS samples selected using IDEA cannot be evaluated using the method just described. If a dollar unit sample results in a significant number of misstatements and projected misstatements approach or exceed design materiality, it may be possible to evaluate the sample using classical variables sampling; however, the evaluation is complex and cannot be done using IDEA. Therefore, the auditor should consult with the Director of Planning and Reporting or designee.

Evaluating the results of a DUS-approximation sample

.38 The projected misstatement is computed using whichever of the following methods the auditor believes to most reasonably reflect the actual misstatements:

a. **Ratio method:** First, for each stratum, other than the top stratum, for which each item is examined, compute a ratio by dividing the sum of all misstatements in sample items by the sum of the sample items and multiply the ratio by the sum of all items in the stratum. Second, add the sum of all misstatements detected in top stratum items to the results of the first step.

b. **Item-average method:** First, for each stratum other than the top stratum, compute an average misstatement amount by dividing the sum of all misstatements in sample items by the number of all the sample items, and multiply the average misstatement amount by the number of all items in the stratum. Second, add the sum of all misstatements detected in top stratum items to the results of the first step.

c. **DUS-approximation method** (for use only if the sample is believed to approximate a DUS sample closely): Calculate the projected misstatement as if the sample were a DUS sample.

Any projected misstatement would be reduced by the amount of any correcting adjustment made by the entity.

Evaluating the results of a classical variables estimation sample

.39 The auditor should consult with the Director of Planning and Reporting or designee in evaluating the results of a classical variables estimation sample.

Evaluating the results of other samples

.40 Misstatements detected in a random or systematic sample based on items rather than dollars should be evaluated by using the ratio or item-average method, as described in paragraph 480.38, whichever the auditor believes to more reasonably reflect the actual misstatements. When misstatements are detected in a sample for which guidance on evaluation is not described above, the auditor should consult with the Director of Planning and Reporting or designee.

EFFECTS OF MISSTATEMENTS ON THE FINANCIAL STATEMENTS

.41 The quantitative and qualitative effects of all misstatements detected in the audit — both known and likely — must be evaluated in relation to the financial statements as a whole. Section 540 provides guidance on this evaluation.

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490 - DOCUMENTATION

.01 The auditor should document the nature, timing, and extent of tests performed during this phase of the audit, as well as the conclusions reached. The auditor should specifically identify the procedures used to obtain substantive assurance for an account balance. This identification is particularly important if detail tests are relied on for complete substantive assurance and supplemental analytical procedures are performed to increase the auditor's understanding of the account balances and transactions.

.02 For example, assume an entity incurs and accounts for operating expenses at 50 locations. After considering the guidance in section 295 C regarding multiple-location audits, the auditor decides to obtain all the required substantive assurance from detail tests. The auditor subjects all operating expenses to a statistical sample and visits only the locations for which selections were made. Assume that the auditor decides to obtain additional knowledge of the current-year operations, particularly for locations not visited, through supplemental analytical procedures at all locations. These procedures consist of comparing current-year operating expenses with prior-year audited information by location and between locations.

.03 In the above situation, the auditor is obtaining the entire required amount of substantive assurance from detail tests. The comparison of the current- and prior-year amounts is considered a supplemental analytical procedure and does not provide substantive audit assurance that the auditor may use to reduce the detail tests. During this supplemental analytical procedure, the auditor may detect misstatements that were not detected during the detail tests. The auditor must consider the implications of these misstatements to determine if the original assessment of combined risk was appropriate and if the amount of substantive testing performed (the detail tests) was adequate. Even though misstatements may be detected during supplemental analytical procedures, these procedures cannot be relied on for substantive assurance.

.04 In the audit program, the auditor generally should explain the objectives of audit procedures. Also, written guidance either within or accompanying the audit program to explain possible exceptions, their nature, and why they might be important, may help auditors focus on key matters, more readily determine which exceptions are important, and identify significant exceptions.

.05 As the audit work is performed, the auditors may become aware of possible reportable conditions or other matters which should be communicated to the auditee. The auditor generally should document and communicate these as described in paragraph 290.02.

.06 Documentation of this phase should specifically include:

- For tests involving sampling:
  - the sampling method used and any key factors regarding selection;
  - the sample size and the method of determining it;
  - the audit procedures performed; and
  - the results of tests, including evaluations of sample results, and conclusions.

- For substantive analytical procedures:
  - the model used to develop the expectation and the basis for the model;
  - 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;
  - explanations for fluctuations considered significant, sources of these explanations, and corroborating evidence obtained;
  - the additional procedures performed and related conclusions if misstatements are detected or if the initial procedures are not considered adequate; and
  - conclusions regarding findings, including proper treatment of any misstatements detected and assessment of any other effects of these misstatements.

- Interim testing procedures (see section 495 C for documentation guidance).

- Any misstatements detected (which also should be referenced to their posting on the Summary of Possible Adjustments (see section 540) where they will be considered further).

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495 A - DETERMINING WHETHER SUBSTANTIVE ANALYTICAL PROCEDURES WILL BE EFFICIENT AND EFFECTIVE

.01 The following factors should be considered when determining whether analytical procedures will be effective and efficient as a substantive test:

- nature of the account balance, the specific audit objective (including the assertions being tested), and any identified inherent or control risks;
- expected availability and reliability of explanations for fluctuations and related corroborating evidence;
- plausibility and predictability of the relationship;
- availability and reliability of data; and
- preciseness of the expectation.

NATURE OF THE ACCOUNT BALANCE, THE SPECIFIC AUDIT OBJECTIVE, AND ANY IDENTIFIED INHERENT OR CONTROL RISKS

.02 Analytical procedures are usually more effective for testing income statement amounts than balance sheet amounts. Balance sheet amounts are more difficult to predict because they are as of a specific point in time. Additionally, income statement amounts generally have relationships with various types of 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 items that are subject to management discretion or are unpredictable, such as repairs or miscellaneous expenses.

.03 The auditor should consider the specific audit objective, including the assertions being tested, and any identified inherent and control risks to determine whether substantive analytical procedures will be effective and efficient in achieving the audit objective and level of assurance. The procedures need to be more effective if inherent and control risks have been identified. 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 judgment and are difficult to measure.

.04 As discussed, the auditor may choose to rely completely on analytical procedures when the level of combined risk has been assessed as high. In these cases, the analytical procedures should be extremely effective and persuasive to serve as the sole source of audit evidence for achieving the audit objective. This level of effectiveness is very difficult to achieve when combined risk is assessed as high; therefore, complete reliance on analytical procedures for substantive assurance in these situations is rare, particularly for balance sheet accounts.

EXPECTED AVAILABILITY AND RELIABILITY OF EXPLANATIONS FOR FLUCTUATIONS AND RELATED CORROBORATING EVIDENCE

.05 Explanations for fluctuations and related, reliable corroborating evidence may not always be readily available. This audit evidence is essential to using analytical procedures as a substantive test. The relative ease of obtaining explanations for significant differences and relevant, reliable corroborating evidence should be considered when determining whether analytical procedures will be the most efficient and effective substantive test.

PLAUSIBILITY AND PREDICTABILITY OF THE RELATIONSHIP

.06 Relationships between the amount being tested (the recorded amount) and other data are an essential component of substantive analytical procedures. The relationships identified and used for these procedures should be good indicators of the account balance of the item being tested. To be considered a good indicator of the recorded balance, the relationship between the recorded amount and the other data should be 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 considered to be 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 estimating payroll expense for salaried employees. Alternatively, there is not usually a plausible relationship between revenue and interest expense; therefore, this relationship would not be used for testing.

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 due to 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 (e.g., 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 identified 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 estimate current-year (1) interest expense using current-year audited, long-term debt amounts and interest rate information or (2) sales revenue based on the auditor's estimate of the expected gross margin percentage applied to the audited cost of sales amounts. When using current-year relationships, the data used to estimate the recorded amount must be audited by a method other than a substantive analytical procedure that uses a relationship with the recorded amount.

.12 The auditor should exercise caution when using prior-year amounts as the basis for the expectation of the current-year recorded amount. The workpapers must document why, in the auditor's judgment, the prior-year amount, and any adjustments to that amount, have a plausible and predictable relationship with the current-year recorded amount. Any adjustments to the prior amount, such as for the effects of inflation, must be supported by reliable data and must be corroborated. Additionally, the

prior-year amount must meet the criteria discussed below for reliable data. The easiest way to meet these criteria is if the prior-year amount is audited.

.13 As an example of prior-year relationship, assume that the payroll raises for the year were authorized at 5 percent and that the number and salary mix of employees have remained relatively stable. In this example, the auditor might 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.

AVAILABILITY AND RELIABILITY OF DATA

Availability of Data

.14 Data needed to perform analytical procedures as a substantive test may not always be readily available. The relative ease of obtaining relevant, reliable data should be considered when determining whether analytical procedures will be the most efficient and effective substantive test.

Reliability of Data

.15 The reliability of the data used is an important in determining the effectiveness of the substantive analytical procedures. The more reliable the data are, the more effective these procedures will be as a substantive test. In assessing of the reliability of data, which is a matter of auditor judgment, the auditor should consider the following:

- the source of the data, including whether the data are audited or unaudited;

- conditions under which the data were 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 particularly important if the auditor is using industry statistics.

.17 Data obtained from entity sources are considered 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 reliability of all sources should be considered.

Audited versus unaudited data

.18 The auditor should consider whether the data are audited or unaudited because audited data are considered more reliable than unaudited data. If data are audited by the entity's IG office, they may be as reliable as data audited by independent auditors if the scope of the IG's work is considered adequate.

.19 Unaudited data are not considered reliable unless procedures are followed to establish their reliability. These procedures could consist of either tests of controls over data production or tests of the data. The extent of such procedures is left to the auditor's judgment. 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 which are sent to the borrowers or by reviewing original loan documents.

Conditions under which the data were gathered

.20 Another consideration of internal data is whether the data were developed under a reliable system with adequate financial reporting or operations controls. In some instances, testing operations controls may be appropriate to assess the reliability of the data used for substantive analytical procedures. The extent of this testing is a matter of the auditor's judgment.

.21 If the system used to develop internal data is computerized rather than manual, the auditor must perform additional procedures before relying on the data. The auditor must test either (1) the controls over the EDP system that generated the report or (2) the data in the report.

.22 An auditor might choose to test operations controls when using entity-prepared statistics for a substantive analytical procedure. For example, the auditor might choose to use Air Force statistics to test the reasonableness of its Airlift Services aircraft operating costs. The auditor might 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 by Aviation Week and Space Technology. The auditor should first determine if the industry statistics are comparable, e.g., if the statistics are for the same or similar types of aircraft and if the types of items included in maintenance costs are similar. If appropriate, the auditor should identify and test the internal controls over the production of these operating statistics.

PRECISENESS OF THE EXPECTATION

.23 The expectation, the auditor's estimate of the account balance, should be precise enough to provide the desired level of substantive audit 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 and inefficient.

.24 To maximize efficiency, the auditor should conduct procedures at the minimum level of effort that can reasonably be expected to provide the amount of assurance needed. 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.

.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.

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495 B - EXAMPLE PROCEDURES FOR TESTS OF SUMMARIZATION OF BUDGET INFORMATION

.01 If budget controls are ineffective and quantitative provisions of budget-related laws and regulations are considered significant, the auditor should perform audit procedures sufficient to detect the types of budget information misstatements listed in paragraph 460.04. Following is an example of procedures for testing expenditure and obligation transactions for these misstatements. (Test materiality for determination of sample sizes is discussed in paragraph 460.05.)

- **Validity, cutoff, recording, and classification:** Select obligations recorded as of the end of the audit period and expenditures recorded during the audit period. Determine if each selected item is a valid obligation or expenditure based on the criteria set forth in section 395 F and if each is recorded in the appropriate period. If the obligation or expenditure is not recorded or is recorded in the incorrect period, determine the effects of this misstatement on budget amounts, and consider whether the auditor's evaluation of budget controls is affected.

  Also determine if each selected item is

  - recorded at the proper amount and

  - classified in the proper account (both by program and by object, if applicable), including the proper appropriation year.

- **Completeness and cutoff:** First, select a sample of obligations and expenditures recorded during the period following the balance sheet date. Second, examine open purchase orders, unpaid invoices, and contracts as of the report date. Third, 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.) For each selection, determine whether the obligation or expenditure is recorded in the proper period. If it is not recorded or is recorded in the incorrect period, determine the effects of this

misstatement on budget amounts, and consider any impact on the evaluation of budget controls.

If the selected obligation or expenditure relates to the audit period and is recorded in that period, determine if it is

- recorded at the proper amount and
- classified in the proper account (both by program and by object, if applicable), including the proper appropriation year.

- **Summarization:** Test the footing of the detail of the obligation account balance recorded as of the end of the audit period and expenditure accounts recorded during the audit period. Then reconcile the total of these details to the recorded totals for obligation and expenditure 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 simultaneously selecting items for this test.)

.02 The audit procedures discussed above for testing expenditures should be coordinated with the audit of the financial statement amounts. For example, if appropriate, the tests of accounts payable for completeness may be coordinated with the selection of subsequent obligations and expenditures described above.

495 C - GUIDANCE FOR INTERIM TESTING

MISSTATEMENTS IN INTERIM BALANCES

.01 The auditor should use judgment to determine whether any misstatements detected in interim tests warrant a revision of (1) the auditor's combined risk assessment and (2) the nature, timing, and extent of planned audit procedures. In determining the effects of such misstatements, the auditor should consider all 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 Any financial statement misstatements detected should be discussed 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 isolated or are likely to occur in the remainder of the line item/account balance at the interim testing date and at the year's end. The auditor should encourage management to correct any such misstatements in the population. Based on the following guidance, the auditor should use judgment to determine the extent, if any, that interim testing can be relied on, in conjunction with substantive tests of the rollforward period, to provide evidence on the year-end line item/account balance:

- If the misstatements are insignificant and are expected to be representative of the year-end balance, the auditor may rely on the results of the interim testing.
- If the misstatements can be isolated (generally by nature, cause, or extent), the auditor may be able to rely on unaffected parts of the interim testing and apply procedures at the year's 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 costing of inventory; accordingly, reliance could be placed on other parts of the interim

testing, such as those for the accuracy of the physical count, and only cost testing and related procedures would be required at the year's end.

- If the misstatements are significant or pervasive, it might be necessary to place no reliance on the interim testing and to perform significant substantive testing of the line item/account balance as of the balance sheet date.

.03 For any misstatements found during interim testing, the auditor should use judgment to evaluate, in a manner appropriate for the circumstances, the effects on the year-end balance.

TESTING THE ROLLFORWARD PERIOD

.04 Because the auditor reports on the financial statements as of the year's end, not the interim test date, additional procedures must be performed to extend the interim conclusions to the year's end. The auditor should make substantive tests of the rollforward period activity or the year-end balance. For example, after interim testing of the accounts receivable balance, the auditor might examine supporting documents for selected debits and credits to the balance during the rollforward period and/or might apply analytical procedures to compare the amount of rollforward activity, on a month-by-month basis, with that of preceding months or similar periods of preceding years.

.05 The auditor should determine the extent of the required substantive procedures based on the assessment of combined risk and test materiality, in substantially the same manner as for other substantive tests. In some instances, the auditor may determine that specific combined risk warrants additional substantive procedures at the year's end (such as cutoff tests). If control risk is moderate or low, the auditor should determine that the internal controls as of the interim testing date were in place and were functioning effectively during the rollforward period (generally by reference to the results of tests of financial reporting controls which generally cover the entire year under audit for significant control systems).

DOCUMENTATION

.06 The auditor should document

- the line items/accounts (and assertions, where applicable) to which interim testing is applied;

- the factors considered when determining whether to use interim testing;
- the audit procedures used to test interim balances and the rollforward period (including tests of controls, findings, and conclusions); and
- the effects of any misstatements found during interim testing.

495 D - AUDIT MATRIX WITH STATISTICAL RISK FACTORS

The following table illustrates the correlation between combined risk and the substantive assurance obtained from substantive analytical procedures and detail test. The table also provides the statistical risk factors to be used for DUS (see paragraph 480.17).

Assessed combined risk level	Substantive assurance	Substantive assurance from analytical procedures[a]	Minimum substantive assurance from detail tests	Statistical risk factor
Low	63%	Complete	0%	N/A*
		Partial	50%	0.7
		None	63%	1.0
Moderate	86%	Complete	0%	N/A
		Partial	77%	1.5
		None	86%	2.0
High	95%	Complete	0%	N/A
		Partial	92%	2.5
		None	95%	3.0

[a] Complete assurance from 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 combined risk is assessed as high. Therefore, complete reliance on analytical procedures for substantive assurance in these situations is rare, particularly for balance sheet accounts.

* Not applicable

495 E - DELETED

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495 F - PERFORMING MANUAL DOLLAR UNIT SAMPLING

.01 To select a DUS sample manually, the following steps should be performed:

a. Determine the sampling interval using the following formula:

Sampling interval = Test materiality ÷ statistical risk factor

b. Clear the adding machine

c. Select and document a random start and enter as a negative number in the adding machine. The random start should be a number between 1 and the sampling interval.

d. Enter the positive amounts in the test population (items) until the calculator's running subtotal becomes positive. The item that caused the subtotal to become positive is the item selected for testing.

[See page 495 F-3. Note that the adding machine subtotals were positive for invoices #3, 10, 17, 19, and 24.]

Do not enter into the adding machine any items in the population with zero or credit balances. These items should be accumulated separately and tested in conjunction with tests of completeness of the account balance or class of transactions if they are expected to be significant.

e. After each selection, subtract the sampling interval until the subtotal is negative. Even if the last item in the population is selected, the sampling interval should be subtracted until the subtotal is negative.

[See page 495 F-3. For invoice #19, the auditor had to subtract the sampling interval twice to get a negative subtotal.]

f. Repeat steps d. and e. until <u>all</u> items in the test population have been entered into the adding machine and the ending subtotal is negative.

g. To test the footing of the population, reconcile the sample to the recorded amount of the test population as follows:

Add:

(a) Random start

(b) Sampling interval multiplied by the number of times the sampling interval was subtracted during selection of the sample

(c) The remaining subtotal on the adding machine.

The total should equal the test population amount.

If the total on the reconciliation is not equal to the population amount, there is either an error in the total population amount or there was an error in entering the population items into the adding machine.

The auditor should consider the amount of any difference when determining whether investigation of the difference is necessary. Immaterial amounts generally do not require investigation.

[See page 495 F-4 for an example reconciliation to test the footing.]

Example of Systematic Selection for DUS

- Random starting point . . . . . $ 6,000
- Sampling interval $50,000

Invoice Register		Adding Machine Tape			
Number	Amount	Entries		Subtotals	Selection
				Start $ 0	
		-	6,000	(6,000)	
1	$ 2,500	+	2,500	(3,500)	
2	2,500	+	2,500	(1,000)	
3	4,500	+	4,500	3,500	X
		-	50,000	(46,500)	
4	12,000	+	12,000	(34,500)	
5	25	+	25	(34,475)	
6	3,500	+	3,500	(30,975)	
7	10,000	+	10,000	(20,975)	
8	8,000	+	8,000	(12,975)	
9	5,000	+	5,000	(7,975)	
10	25,000	+	25,000	17,025	X
		-	50,000	(32,975)	
11	1,000	+	1,000	(31,975)	
12	500	+	500	(31,475)	
13	7,000	+	7,000	(24,475)	
14	10,500	+	10,500	(13,975)	
15	12,000	+	12,000	(1,975)	
16	1,275	+	1,275	(700)	
17	9,500	+	9,500	8,800	X
		-	50,000	(41,200)	
18	10,000	+	10,000	(31,200)	
19	100,000	+	100,000	68,800	X
		-	50,000	18,800	
		-	50,000	(31,200)	
20	20,200	+	20,200	(11,000)	
21	1,800	+	1,800	(9,200)	
22	4,000	+	4,000	(5,200)	
23	250	+	250	(4,950)	
24	20,550	+	20,550	15,600	X
		-	50,000	(34,400)	
25	20,000	+	20,000	(14,400)	
	$291,600				

Reconciliation of book amounts footed to test population:

	Random start	$ 6,000
+	Sampling interval × number of times subtracted ($50,000 × 6)	300,000
+	Remaining subtotal	(14,400)
	Population total	$291,600

SECTION 500

Reporting Phase

Figure 500.1: Methodology Overview

Planning Phase	Section
· Understand the entity's operations	220
· Perform preliminary analytical procedures	225
· Determine planning, design, and test materiality	230
· Identify significant line items, accounts and assertions	235
· Identify significant cycles and accounting applications	240
· Identify significant provisions of laws and regulations	245
· Identify relevant budget restrictions	250
· Assess inherent risk and the control environment	260
· Determine likelihood of effective EDP-related controls	270
· Identify relevant operations controls to evaluate and test	275
· Plan other audit procedures	280
· Plan locations to visit	285

Internal Control Phase	Section
· Understand internal control systems	320
· Identify control objectives	330
· Identify and understand relevant control techniques	340
· Determine the nature, timing, and extent of control tests	350
· Perform nonsampling control tests	360
· Assess controls on a preliminary basis	370

Testing Phase	Section
· Consider the nature, timing, and extent of tests	420
· Design efficient tests	430
· Perform tests and evaluate results	440
·· Sampling control tests	450
·· Compliance tests	460
·· Substantive tests	470
··· Substantive analytical procedures	475
··· Substantive detail tests	480

Reporting Phase	Section
· Perform overall analytical procedures	520
· Determine adequacy of audit procedures and audit scope	530
· Evaluate misstatements	540
· Conclude other audit procedures:	550
·· Inquire of attorneys	
·· Consider subsequent events	
·· Obtain management representations	
·· Consider related party transactions	
· Determine conformity with the entity's accounting principles	560
· Determine compliance with GAO Financial Audit Manual	570
· Draft reports	580

510 - OVERVIEW

.01 Based on the work in the preceding phases, the auditor must form conclusions on the information in the principal statements, the entity's internal controls, the entity's compliance with laws and regulations, and other information (the overview of the reporting entity, the combining statements and supplemental financial and management information). Additionally, findings coming to the auditor's attention should be reported in an appropriate manner. The following sections provide guidance to assist the auditor in making these determinations and in formulating the report type and form. Guidance is also provided on other activities that should be performed by the auditor during the reporting phase. (See figure 500.1.)

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520 - PERFORM OVERALL ANALYTICAL PROCEDURES

PURPOSES OF OVERALL ANALYTICAL PROCEDURES

.01 As the audit nears completion, the auditor must perform overall analytical procedures as required by GAAS (AU 327). These procedures, which are part of the reporting phase, have the following purposes:

- to determine if an adequate understanding of all fluctuations and relationships in the principal statements has been obtained from other audit procedures,
- to determine if other audit evidence is consistent with explanations for fluctuations documented during overall analytical procedures, and
- to assist the auditor in forming an opinion on the principal statements that is consistent with the conclusions reached during tests of individual account balances and classes of transactions.

.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, further inquiries and testing are necessary to obtain an adequate understanding or to resolve the inconsistencies.

.03 The auditor may find it effective and efficient to perform overall analytical procedures in more detail than the financial statement level (supplemental analytical procedures) and then use the results of these procedures to "roll up" into and support the overall analytical procedures at the financial statement level.

.04 For example, the auditor may choose to 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 information obtained during these procedures can be used as the basis for explanations of fluctuations for overall analytical procedures.

.05 Having the auditor who conducted the detail tests on an account also conduct supplemental analytical procedures usually maximizes efficiency and effectiveness by building on the knowledge of the account obtained during detail tests.

.06 Overall analytical procedures should be coordinated with the auditor's evaluation of the overview of the entity included in the annual financial statement. For example, the auditor should use the overview, if available, to assist in performing overall analytical procedures and should use the results of the analytical procedures to assist in forming conclusions about the information in the overview.

PERFORMANCE OF OVERALL ANALYTICAL PROCEDURES

.07 The auditor should take the following steps to achieve the purposes of overall analytical procedures described above:

- **Compare current-year amounts with comparative financial information and with budget execution information:** This information should be on a summarized level, such as the level of principal statements. If available, audited prior-year information that is comparable to the current-period information should be used for comparison. If audited prior-year information is not available, the auditor should use any other information that provides a reasonable basis for comparison. The audited, adjusted amounts for the current year must be used for these procedures. The auditor may also perform ratio analysis on current-year data and compare these with ratios derived from prior periods or budgets.

- **Identify significant fluctuations:** The auditor should establish parameters for determining if a fluctuation is significant. Fluctuations identified are a matter of the auditor's judgment. The auditor should also consider the absence of expected fluctuations when identifying significant fluctuations.

- **Understand identified fluctuations:** The auditor should understand all fluctuations identified. The causes for the fluctuations should be briefly described and referenced to corroborating evidence in the workpapers. If the auditor does not understand the cause of the fluctuation or if the understanding is not consistent with the evidence in the workpapers, the auditor should perform appropriate procedures to obtain an understanding or to resolve any inconsistencies.

- **Consider the results of overall analytical procedures:** The auditor should consider these results to determine if an adequate understanding of significant fluctuations was obtained and evidence is consistent and adequate to support the report on the principal statements.

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530 - DETERMINE ADEQUACY OF AUDIT PROCEDURES AND AUDIT SCOPE

.01 In the planning phase, the auditor determined planning materiality based on preliminary information. Based on planning materiality, the auditor determined design and test materialities, which affected the extent of testing. In light of the final assessment of combined risk and the audited materiality base, the auditor should consider whether the extent of substantive audit procedures was sufficient (i.e. appropriateness of sample sizes for detail tests and the limit for investigation of differences during substantive analytical procedures). When there are questions regarding the adequacy of work performed, the auditor should consult with the Director Planning and Reporting or designee to determine the necessity of additional procedures.

.02 When determining whether an opinion can be expressed on the principal statements, any limitations on the extent of work performed (audit scope) should be considered. Additional guidance on scope limitations and their impact is provided in paragraphs 580.14-.18.

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540 - EVALUATE MISSTATEMENTS

OVERVIEW

.01 The auditor may detect misstatements during substantive tests or other procedures. These misstatements should be evaluated in both quantitative and qualitative terms. Based on this evaluation, the auditor should determine the type of report to issue on the principal statements.

.02 Additionally, the auditor needs to consider the implications of misstatements on:

- the auditor's evaluation of internal controls (see paragraphs 580.31-.57)

  Consider whether the misstatements indicate control weaknesses that had not been previously identified, whether the assessment of the controls remains appropriate, and whether the categorization of control weaknesses for reporting purposes is appropriate.

- the entity's compliance with laws and regulations (see paragraphs 580.58-69)

  Consider whether the misstatements would change the auditor's conclusions with respect to the entity's compliance with laws and regulations.

- budget formulation and execution

  Consider whether the misstatements would have a significant impact on budget related matters for purposes of reporting budget control weaknesses, reporting on the statements of budgetary resources and financing, and reporting on compliance with budget-related provisions of laws and regulations.

- other reports

  Consider whether the misstatements and any underlying internal control weaknesses affect reported performance measures or other reports prepared by the entity that are (1) used for management decision making or (2) distributed outside the entity.

.03 The auditor should follow the guidance in sections 475 (substantive analytical procedures) and 480 (substantive detail tests) regarding evaluation of individual misstatements from a quantitative standpoint. Following that guidance, the auditor should quantify the effects of the misstatements and classify them as follows:

- **known misstatement:** the amount of misstatement actually found,

- **likely misstatement:** the auditor's best estimate of the amount of the misstatement (including the known misstatement). For sampling applications, this amount is the projected misstatement.

ACCUMULATION OF MISSTATEMENTS

.04 To evaluate the aggregate effects of misstatements on the principal statements, the auditor should accumulate the adjustments necessary to correct all known and likely misstatements on the Summary of Possible Adjustments. This schedule should include all misstatements detected by the auditor, <u>including any that the entity corrected during the audit</u>. It is important to consider all misstatements to have a record of the impact of the audit, to bring all misstatements to the attention of the appropriate level of management, and to assist the auditor in evaluating the risk of further misstatement as a part of the consideration of unadjusted misstatements (paragraphs 540.11-.12). An example format is included as section 595 C. The Director of Planning and Reporting or designee should review the Summary of Possible Adjustments.

.05 The principal statements usually include various estimates made by management, such as the recoverability of assets (allowances for doubtful accounts receivable or loans) and liabilities for loan guarantees. If the recorded amount falls outside of a range of amounts that the auditor considers reasonable, the auditor should consider the difference between the recorded amount and the closest end of the auditor's range to be a likely misstatement that should be included on the Summary of Possible Adjustments and should discuss the difference with entity management.

.06 Additionally, the auditor should consider whether management's estimates consistently overstate or understate components of the principal statements, such as total assets or total expenditures. If so, the auditor should consider the effects on the principal statements in addition to any unadjusted misstatements when determining the appropriate type of

opinion. Further guidance on evaluating estimates is provided in AU 312.29.

REVIEW OF MISSTATEMENTS WITH MANAGEMENT

.07 After accumulating and summarizing the adjustments, the auditor

- **must** bring all misstatements found (except those which are clearly insignificant) to the attention of appropriate entity management (generally at least one level of management above those involved), and

- **should** encourage entity management to adjust the entity's records to correct all known misstatements found and to establish valuation allowances for likely misstatements, net of known misstatements.

MANAGEMENT DISAGREEMENT WITH LIKELY MISSTATEMENTS

.08 If management disagrees with the auditor's likely misstatements and if the disagreement is material in amount, the auditor may consider the following options:

- The entity may perform procedures, such as reviewing all or substantially all of the items in the relevant population, to refine the estimated amount of the misstatement. In these situations, the auditor should test management's procedures and conclusions.

- The auditor may believe that sufficient evidence has already been obtained and may form his/her opinion on the principal statements based on his/her estimate.

- The auditor may desire to increase assurance in the likely misstatements in order to convince entity management of the amount or to support the report on the principal statements. For example, the auditor may choose to increase his/her assurance in the likely misstatement by testing additional items. These additional procedures will most likely increase the auditor's assurance in the previous findings but generally will not materially affect the amount of the likely misstatement. Before deciding to perform additional procedures, the auditor should obtain agreement from entity management on the extent of additional evidence needed to be persuasive to them. The auditor also should consult with the Director Planning and Reporting or designee before beginning any of these additional procedures.

CONSIDERATION OF UNADJUSTED MISSTATEMENTS

.09 If entity management declines to record adjustments for any misstatements, the auditor must consider the potential effects of these misstatements on the auditor's report in both quantitative and qualitative terms. The auditor should prepare a Summary of Unadjusted Misstatements, generally following the format provided in section 595 D. Overall guidance on evaluating misstatements is provided in AU 312.27-.32. If total unadjusted likely misstatements are material, the auditor should modify the opinion on the principal statements (see paragraph 580.21). Misstatements, 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. Deciding whether and how to modify the opinion based on the materiality of total unadjusted likely misstatements is a significant auditor's judgment. The decision and the basis for it should be documented in a memo. The director should be involved in the decision and review the documentation related to it. Also, the Director of Planning and Reporting or designee should review and approve the memo documenting the decision.

Quantitative Considerations

.10 Although there is some point where unadjusted likely misstatements would generally be considered material, there is no single amount that can be used for deciding to modify the opinion. Instead, the auditor should follow a process that considers a number of quantitative factors in reaching this decision.

.11 While the auditor could simply compare total unadjusted likely misstatements with important aspects of the financial statements taken as a whole, the auditor recognizes that total likely misstatement is an estimate and that there is a risk of further misstatement. This risk relates to the imprecision of audit procedures. This risk includes the allowance for sampling risk (the combined precision of all sampling applications), an allowance for imprecision of analytical and other substantive audit procedures, and an allowance for unaudited immaterial account balances.

.12 Thus, to total unadjusted likely misstatements the auditor should add an allowance for the imprecision of audit procedures. This total should then be considered in relation to planning materiality and the relative importance

of the misstated items to readers of the financial statements to determine whether the financial statements as a whole may be materially misstated. For example, if the aggregate unadjusted likely misstatement is $10 million and the allowance for imprecision of audit procedures is probably no more than $15 million, the auditor should determine whether the total ($25 million) materially misstates the financial statements taken as a whole. A designee of the Director of Planning and Reporting should be consulted in considering these issues.

.13 The auditor's report addresses the fair presentation of the principal statements as a whole. When considering the effects of any unadjusted misstatements on the principal statements, the auditor should bear in mind that he/she is taking less responsibility for individual line items in the principal statements and in any combining statements and supplemental schedules than for the principal statements as a whole.

Qualitative Considerations

.14 The auditor should consider numerous qualitative factors when determining the effect of unadjusted misstatements on the auditor's report. The auditor may choose to modify or qualify the report on the principal statements, even if the amounts of any unadjusted misstatements are not quantitatively material. Examples of misstatements for which the auditor may consider issuing a modified or qualified report include

- misstatements of account balances or transactions that are considered sensitive to the financial statement users;

- misstatements that offset one another in the aggregate but are individually significant; and

- misstatements that have a significant effect on the overview presented by management, including the entity's performance indicators.

Treatment of Unadjusted Misstatements Detected in Prior Periods

.15 The auditor should consider the effects on the current-period principal statements of any misstatements detected in prior periods. If corrected in the current period, the auditor should record the impact on current-period principal statements in the Summary of Possible Adjustments. For example, a prior-period understatement of expense corrected in the current period might result in a current-period overstatement of expense. If

uncorrected, the auditor should consider the misstatement in combination with current-period misstatements. Guidance is provided in AU 312.30.

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 determine if the misstatement is material to the prior- or current-period principal statements. If the misstatement is considered to be material, the auditor should consult the Director of Planning and Reporting to determine the effects, if any, on the current-period statements and the auditor's report. Any material misstatements of this type should be discussed with entity management and should be included on the Summary of Possible Adjustments if not corrected through a prior-period adjustment to the principal statements.

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550 - CONCLUDE OTHER AUDIT PROCEDURES

.01 To issue the auditor's report, procedures in the following areas should be concluded during the reporting phase:

- inquiries of attorneys (see paragraphs 550.02.-.03),
- subsequent events (see paragraphs 550.04.-.06),
- management representations (see paragraphs 550.07-.10), and
- related party transactions (see paragraph 550.11).

INQUIRIES OF ATTORNEYS

.02 In considering any contingent liabilities or uncertainties that may affect the entity or its principal statements, the auditor should make inquiries of the entity's counsel regarding litigation, claims, and assessments. Guidance on these inquiries, as well as on interpreting and using responses received from counsel, is provided in AU 337 and 9337.

.03 The inquiries and responses should cover the entire period under audit and the subsequent period through completion of field work (the date of the auditor's report). A response should be obtained from counsel at the approximate end of field work. If a long period elapses from end of field work to report issuance, a subsequent update generally should be obtained, either written or oral (and documented in the workpapers), for material events to report issuance.

SUBSEQUENT EVENTS

.04 Events or transactions may occur after the balance sheet date but before auditor's report is issued. Such events or transactions that have a material effect on the principal statements and therefore require adjustment to or disclosure in the principal statements are referred to as subsequent events. Section 1005 (Part II) and AU 560 provide guidance on determining whether a particular subsequent event requires adjustment to or disclosure in the principal statements.

.05 To identify subsequent events that would require either adjustment to or disclosure in the principal statements, the auditor should follow the

procedures described in Section 1005 and AU 560.10-12. These procedures should be performed at or near the completion of fieldwork. If a long period elapses from end of field work to report issuance, the procedures generally should be updated for material events through the issuance of the auditor's report. The auditor should follow the guidance in AU 530 on dating the auditor's report if any subsequent events are identified that affect the report.

.06 The auditor generally has no obligation to perform procedures to identify subsequent events after the report is issued. If the auditor becomes aware of facts that might have affected the report if they had been known before issuance, the auditor should follow the guidance in AU 561.

MANAGEMENT REPRESENTATIONS

.07 The auditor is required to obtain written representations from management as part of the audit. 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. Section 1001 (Part II), AU 333.04, AT 400.42, and AU 801.07 provide examples of the written representations usually obtained from management. Additionally, the auditor may request representations on other matters.

.08 If management refuses to provide the requested written representations, the auditor must consider this a limitation on the audit scope, and the auditor's report must be modified (See paragraphs 580.14-.18). In these situations, the auditor should consider the reliability of other representations received from management during the audit.

.09 The representation letter should be signed by members of management who, in the auditor's view, are responsible for and knowledgeable, directly or through others, about the matters in the representation letter, as discussed in AU 333.09.

.10 The representation letter should be dated as of the date of the auditor's report. If there is a significant delay between the report date and the issuance of the report, the auditor should consider obtaining updated management representations.

RELATED PARTY TRANSACTIONS

.11 The auditor should be aware of the possible existence of relationships with related parties and material related party transactions that could affect the principal statements. Section 1006 and AU 334 provide guidance on identifying related parties, examining related party transactions, and considerations for disclosure.

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560 - DETERMINE CONFORMITY WITH THE ENTITY'S ACCOUNTING PRINCIPLES

.01 Generally accepted accounting principles for federal government entities are being developed by the Federal Accounting Standards Advisory Board (FASAB), an entity created by GAO, OMB, and Treasury. FASAB recommends federal accounting standards to the Comptroller General, the Secretary of the Treasury, and the Director of OMB (the three principals). The accounting standards agreed upon by these three officials are issued by the Comptroller General and the Director of OMB. Federal executive agencies are to follow the hierarchy of accounting principles given below. This means that the entity is to use the guidance in item 1 unless that item is silent about a particular topic. In that case, the entity is to use the guidance in item 2, unless it also does not address the topic, and so on to item 3 or 4 until guidance addressing the topic is found. This hierarchy is recognized by OMB and GAO as an "other comprehensive basis of accounting," per OMB Bulletin 94-01, dated November 16, 1993, and a December 1, 1993, directive from the Comptroller General to Heads of Departments and Agencies. (Government corporations generally follow generally accepted accounting principles.)

1. The accounting principles, standards, and requirements approved by the three principals.

2. Form and content requirements for financial statements included in OMB Bulletin 93-02, dated October 22, 1992, and subsequent issuances. (The first subsequent issuance was OMB Bulletin 94-01.)

3. Other accounting standards and related disclosure requirements contained in agency accounting policy procedures manuals, and/or related guidance as of March 29, 1991, so long as they are prevalent practices. (As of March 29, 1991, according to the Comptroller General's directive, most agencies' manuals and related guidance adopted the requirements of title 2 of the GAO Policy and Procedures Manual for Guidance of Federal Agencies existing prior to the approval of FASAB's recommended accounting standards.)

4. Accounting principles published by authoritative standard-setting bodies or other authoritative sources (1) in the absence of other guidance listed above and (2) if the use of such accounting standards improves the meaningfulness of the financial statements.

.02 Entities are required to summarize the significant accounting policies used in the notes to the principal statements.

.03 Until generally accepted accounting principles for federal entities are completed, the auditor should follow the guidance in AU 623 for financial statements prepared on a basis of accounting other than generally accepted accounting principles to determine if

- the policy has been adequately disclosed,
- the policy has been consistently followed, and
- adequate informative disclosures have been made.

.04 The auditor should review the principal statements for conformity with the entity's basis of accounting and should identify any instances of nonconformity. Such nonconformity may include incomplete disclosure or use of an accounting principle that is contrary to the entity's basis of accounting, as described in the entity's financial manual. A Checklist for Reports Prepared Under the CFO ACT is in section 1004 (Part II) for reviewing the principal statements for appropriate and adequate disclosure in accordance with the basis of accounting.

.05 The auditor should consider the impact of nonconformity with the entity's accounting principles on the principal statements and should determine the effects, if any, on the auditor's report (see paragraph 580.21).

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570 - DETERMINE COMPLIANCE WITH GAO FINANCIAL AUDIT MANUAL

.01 The auditor must determine whether the audit was conducted in accordance with GAGAS, OMB Bulletin 93-06, and GAO financial audit methodology. The auditor should use the audit completion checklist included in section 1003 (Part II) for determining and documenting compliance.

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580 - DRAFT REPORTS

.01 At the conclusion of the audit, the auditor finalizes the draft of the auditor's report which includes the auditor's opinions or conclusions on

- the principal statements (see paragraphs 580.10-.30),
- management's assertion about the effectiveness of internal controls (see paragraphs 580.31-.57),
- compliance with laws and regulations (see paragraphs 580.58-.66), and
- the overview and other information included in the annual financial statement (see paragraphs 580.67-.69).

.02 The auditor's report should clearly identify the entity audited, the annual financial statement on which the auditor is reporting, and the period covered by the annual financial statement.

.03 The report should be dated as of the completion of fieldwork. If a subsequent event occurs after that time that requires disclosure in the report, the auditor should follow the guidance in AU 530 with respect to dating the report.

REPORT FORMAT

.04 An illustrative unqualified auditor's report on the annual financial statement is presented in section 595 A. The auditor should document the reasons for deviations from the illustrative reporting format or language in sections 595 A and/or B, or from the language required by the professional standards. The report typically includes the following sections:

- Introduction
- Significant matters (when applicable)
- Conclusions
  - principal statements
  - internal controls
  - compliance with laws and regulations
  - consistency of other information,
- Objective, scope, and methodology, and
- Agency comments and our evaluation (if applicable).

.05 The introduction summarizes the auditor's conclusions on the entity's principal statements, internal controls, and compliance with laws and regulations.

.06 A significant matters section is included if any of the following situations exist:[1]

- significant limitations on the scope of the audit (paragraphs 580.14-.18, .33-.34, and .63-.65);
- uncertainties for which the auditor disclaimed an opinion (paragraph 580.19);
- material departures from established accounting principles (paragraph 580.21);
- material weaknesses in internal controls (including performance measures controls) or other weaknesses that the auditor has decided to describe in the audit report (paragraphs 580.48-.52);
- instances of noncompliance that are reportable under GAGAS or OMB Bulletin 93-06, i.e., any that are not clearly inconsequential (paragraphs 580.59-.61);
- material inconsistencies between other information (overview, combining statements, and other supplemental financial and management information) and the principal statements or material nonconformity of the other information with OMB guidance for such information (paragraphs 580.67-.69);
- material conflicts between the Summary of Managements' Report on Internal Controls prepared under FMFIA and the results of the auditor's evaluation of internal controls (paragraph 580.66); or
- any other significant matters coming to the auditor's attention, that in his/her judgment, should be communicated to the entity head, OMB, and the Congress.

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[1] The auditor may include certain other matters in this section as discussed in paragraphs 580.25-.26.

This section should be phrased similar to an executive summary. Matters should be described in non-technical language so that report users can readily grasp their significance. Other sections of the report would not repeat this narrative, but would refer to it using phrases such as "as described above." If two or more of the above items affect the same area, the auditor should combine the discussion of the situations to the extent possible. Each significant matter should begin with a summary heading. Also, if significant matters exist, the auditor's report should indicate that such matters were considered in forming the audit conclusions (as discussed in section 595 B, note 1).

.07 The conclusions section of the report is used to report the auditor's overall conclusions on the principal statements, internal controls, compliance with laws and regulations and consistency of other information.

.08 The objectives, scope, and methodology section includes a discussion of management's and the auditor's responsibilities, what the auditor did to fulfill his/her responsibilities, the scope of the auditor's work on internal controls, and a statement that the audit was performed in accordance with GAGAS and OMB Bulletin 93-06.

.09 The remainder of this section provides guidance on forming conclusions on the principal statements, internal controls, compliance with laws and regulations and other information.

- Example report wording of an unqualified auditor's report on the annual financial statement is included in section 595 A.

- Section 595 B provides guidance on modifying the report based on the auditor's conclusions. In some cases, when findings are extensive, the report format may also be modified.

PRINCIPAL STATEMENTS

.10 Under GAAS, the fourth standard of reporting on financial statements follows:

> "The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report

should contain a clear-cut indication of the character of the auditor's work, and the degree of responsibility the auditor is taking."

.11 When reporting on principal statements, the following areas must be considered: (1) audit scope, (2) uncertainties, (3) consistency, and (4) departures from established accounting principles. Each of these areas and their effects on the report are discussed below.

.12 The auditor must consider these four areas and results of all audit procedures performed to determine if an opinion can be expressed on the principal statements and, if so, the type of opinion. If an opinion cannot be expressed, the auditor should issue a disclaimer report. If an opinion can be expressed, the auditor may issue one of the following opinion types: unqualified, unqualified with an explanatory paragraph, qualified or adverse. Each of these reports is discussed below.

.13 The auditor should formulate the type of report on the principal statements following the guidance provided below and in sections 595 A and 595 B.

Audit Scope

.14 To express an opinion, first the auditor must determine if the audit has been conducted in accordance with GAGAS and OMB Bulletin 93-06. If the auditor is not able to perform all procedures considered necessary, the scope of the audit is considered to have been limited or restricted.

.15 Restrictions on the scope of the auditor's work may be imposed by the entity or may be caused by circumstances beyond the entity's control. Scope limitations may result from the timing of the audit work; the inability to obtain sufficient, competent evidential matter; or inadequate accounting records. If the audit scope has been limited, the auditor should refer to the guidance in AU 508.22-.28 to determine whether to qualify or disclaim an opinion.

.16 When determining if sufficient competent evidence has been obtained, the auditor should consider the impact of any misstatements on the audit scope from a qualitative standpoint. The auditor should also consider whether the audit scope is adequate in light of any misstatements or other findings that indicate noncompliance with laws and regulations.

.17 Whether to qualify or disclaim an opinion because of a scope limitation is a matter of the auditor's judgment. The auditor should assess how important

the omitted procedures were to his/her ability to form an opinion on the principal statements. 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.

.18 If the audit scope is adequate for expressing an opinion, the auditor must determine the appropriate type of opinion. Three areas that the auditor should consider when forming the opinion are uncertainties, consistency, and departures from established accounting principles.

Uncertainties

.19 Uncertainties are matters affecting the principal statements whose outcome is expected to be resolved at a future date when conclusive evidential matter will become available. Uncertainties may be related to the resolution of litigation or the valuation of assets, such as real estate owned. Uncertainties include the contingencies discussed in SFFAS No. 5 and FASB Statement No. 5, estimates covered by AICPA Statement of Position 94-6, as well as other matters. Guidance on considering uncertainties and their effects on the auditor's report is provided in AU 508.29-.32 (SAS 79). Depending on the nature of the uncertainty, the auditor may need to add an explanatory paragraph, or disclaim an opinion, as discussed in AU 508. Because of the nature of uncertainties, conclusive evidence cannot be expected to exist at the time of the audit. 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 required disclosures. The auditor generally should give an unqualified opinion if, in his or her 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 add a matter of emphasis paragraph; see AU 508.19.) Additionally, if the uncertainty involves a scope limitation (unavailable or insufficient evidence to support recorded amounts or disclosure relating to the uncertainty) a qualification or disclaimer may be appropriate as discussed in paragraphs 580.27 and .30 (see AU 508.29-.32). If the uncertainty involves a departure from accounting principles (inadequate disclosure, inappropriate accounting principles, and unreasonable accounting estimates), the auditor may need to express a qualified or adverse opinion as discussed in paragraphs 580.27 and .29 respectively (see AU 508.45-.49).

Consistency

.20 The auditor is concerned with comparability between the principal statements for all periods presented or with the prior period if only one year is presented. A lack of comparability may be caused by an inconsistency in the accounting principles used; the method of applying these principles; or other factors, such as the classification of accounts for reporting purposes. For first-year audits, the auditor should determine if accounting principles are consistent with the prior period, following the guidance in AU 420.21 -.24. Guidance on the auditor's consideration of accounting and other changes that may affect the consistency of the principal statements may be found in AU 420. Inconsistencies may result in an explanatory paragraph or departure from established accounting principles. Guidance on reporting on a lack of consistency is provided in AU 508.16-.18.

Departure from established accounting principles

.21 The auditor must consider whether the principal statements are materially affected by a departure from the entity's established accounting principles. If such a departure exists, the auditor should determine the extent of the effects of the departure on the principal statements, considering both quantitative and qualitative factors as discussed in AU 508.35-.36. The auditor also should consider whether adequate disclosures have been made in the principal statements and related notes (see AU 431 and AU 508.41-.44) and should evaluate whether any changes in accounting principles used by the entity are appropriate (see AU 508.50-.57). Depending on the extent of the departure, the auditor should express either a qualified or adverse opinion. Guidance on reporting these departures is included in AU 508.37-.40 for qualified opinions and AU 508.58-.60 for adverse opinions (see section 595 B for modifications to be made to the auditor's report). In rare cases when compliance with accounting principles would result in misleading principal statements, a departure from established accounting principles may not result in a qualified or adverse opinion (see AU 508.14 -.15).

Types of reports

.22 As discussed, the auditor may express various types of opinions or may disclaim an opinion. Guidance on reporting is included in AU 411, 420, 431, 504, 508, and 558. Additionally, section 595 A includes an example of an unqualified report. Section 595 B includes specific changes to be made

to the unqualified report under various circumstances. Each type of report is discussed below in paragraphs 580.23-.30.

Unqualified Opinion

.23 In an unqualified opinion on the principal statements, the auditor concludes that the principal statements and accompanying notes present fairly, in all material respects, the assets, liabilities, and net position of the entity at the end of the period, and the net costs, changes in net position, budgetary resources, reconciliation of net costs with budgetary obligations, and custodial activity (if applicable) for the period then ended, on the entity's basis of accounting.

.24 If, in the auditor's judgment, he/she cannot make this conclusion (for reasons discussed in paragraphs 580.14-.21) the auditor's report on the principal statements should be modified. This report modification may take the form of an explanatory paragraph, or the opinion expressed in the report may be qualified or adverse. Additionally, if the auditor opines only on the balance sheet, the auditor should follow the guidance in AU 508.33-.34.

Explanatory Paragraphs

.25 An auditor may express an unqualified opinion and also include explanatory paragraphs in the report. An explanatory paragraph may be included in either the significant matters section or the opinion on financial statements section of the auditor's report based on the auditor's judgment about its significance. The following types of situations usually require the addition of an explanatory paragraph or other explanatory language. (See AU 508.11 for further guidance.)

- The auditor's opinion refers to another auditor's report.
- The predecessor auditor's report is not presented for comparative principal statements.
- The accounting principles or their method of application materially changes between periods. (See paragraph 580.20 for a discussion of consistency.)
- Certain circumstances exist relating to reports on comparative principal statements. (See AU 508.68-.69 and .72-.74.)

- Supplementary information required by FASB or OMB has been omitted, the presentation of such information departs materially from FASB or OMB guidelines or is materially inconsistent with information in the principal statements, the auditor is unable to complete prescribed procedures concerning such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to FASB or OMB guidelines. (See AU 558 for guidance on required supplementary information.)

- There is substantial doubt about the entity's ability to continue to carry out its mission without substantial additional resources or changes in operations (see AU 341).

.26 An explanatory paragraph may also be added to emphasize a matter, such as significant transactions with related parties, as discussed in AU 508.19. Also, although no longer required, an explanatory paragraph may be added when the principal statements are affected by uncertainties concerning future events whose outcome cannot be reasonably estimated as of the report date. (See paragraph 580.19 for a discussion of uncertainties.)

Qualified Opinion

.27 A qualified opinion states that except for the effects of the matter to which the qualification relates, the principal statements present fairly, in all material respects, the assets, liabilities, and net position, net costs, changes in net position, budgetary resources, reconciliation of net costs with budgetary obligations, and custodial activities (if applicable) in conformity with the entity's accounting principles. Guidance on qualified opinions is provided in various paragraphs of AU 508.

.28 The following situations may require a qualified opinion, as discussed in AU 508.20:

- The audit scope is limited (see paragraphs 580.14-.18.)

- Based on the audit results, the auditor believes that a departure from the entity's accounting principles has a material effect on the principal statements, but the auditor has concluded not to express an adverse opinion (see paragraph 580.21.)

AU 508.21 provides guidance on qualified opinions. Section 595 B provides guidance on specific report modifications for qualified opinions.

Adverse Opinion

.29 An adverse opinion states that the principal statements do not fairly present the assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs with budgetary obligations, or custodial activities (if applicable) in conformity with the entity's accounting principles. This type of opinion is expressed on the principal statements taken as a whole when there are material departures from established accounting principles as discussed in paragraph 580.21. Guidance on adverse opinions is provided in AU 508.58-.60. Section 595 B provides specific report modifications for adverse opinions.

Disclaimer Report

.30 In a disclaimer report, the auditor does not express an opinion on the principal statements. A disclaimer report is appropriate when the audit scope is not sufficient to enable the auditor to express such an opinion as discussed in paragraphs 580.14-.18 or when there are material uncertainties as discussed in paragraph 580.19. AU 508.61-.63 provides guidance on issuing disclaimer reports. The reasons that caused the auditor to disclaim an opinion should be described in the significant matters section of the report following the guidance in AU 508.25-.26. Specific guidance on the wording of disclaimer reports is included in section 595 B.

INTERNAL CONTROLS

.31 In federal financial audits conducted by GAO the auditor's responsibilities extend beyond those stated in GAGAS with regard to the entity's internal controls. The auditor should express an opinion on management's assertion about whether the internal controls in effect at the end of the period are sufficient to meet the following control objectives insofar as those objectives pertain to preventing or detecting losses, noncompliance, or misstatements that would be material in relation to the principal statements:

- Assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

- Transactions are executed in accordance with budget authority and with laws and regulations that could have a direct and material effect on the financial statements or that are listed in OMB Bulletin 93-06 and could have a material effect.

- Transactions are properly recorded, processed, and summarized to permit the preparation of reliable financial statements and to maintain accountability for assets.

The auditor should also report any reportable conditions detected in performance measures controls but does not need to express an opinion on whether internal controls are sufficient to meet the objective that data supporting performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

.32 The auditor's evaluation of the entity's internal controls and the results of other audit procedures form the basis for the auditor's opinion on management's assertion about the effectiveness of internal controls. The auditor concludes as to the effectiveness of internal controls (see paragraphs 580.33-.46), then forms an opinion on management's assertion about the effectiveness of internal controls by comparing his or her conclusion with management's assertion (see paragraph 580.47). The opinion may be unqualified, unqualified with reference to reportable conditions, qualified, or adverse. Additionally, there may be restrictions on the scope of the procedures that result in a qualified opinion or a disclaimer report (see paragraphs 580.33-.35). The auditor should communicate any identified internal control weaknesses (including weaknesses in operations controls) as discussed in paragraphs 580.48-.55 and consider the effects of such weaknesses on other reports prepared by the entity (paragraph 580.57).

Scope of Procedures

.33 To express an unqualified opinion on management's assertion about the effectiveness of internal controls, the auditor must be able to perform all of the procedures considered necessary, as described in sections 300 and 450. If there is a restriction on the scope of the audit (i.e., not all of these procedures can be performed), the auditor may need to qualify or disclaim the opinion on management's assertion about the effectiveness of internal controls. Scope restrictions may be imposed by the entity or may be due to other circumstances, such as inadequate staff resources. The decision of whether to qualify or disclaim an opinion is a matter of the auditor's judgment regarding the importance of the omitted procedures to forming an opinion on internal controls. However, if a significant scope restriction is imposed by the entity, the auditor should disclaim an opinion.

.34 When determining the severity of a scope limitation on internal controls, the auditor should consider the three control objectives listed in the report - safeguarding assets, compliance with budget authority and laws and regulations, and financial reporting. If the scope of work on internal controls relevant to one of these objectives is limited, the auditor may need to qualify or disclaim the opinion on management's assertion about the effectiveness of internal controls regarding that objective. Also, the auditor should determine whether that limitation affects his/her ability to opine on management's assertion about the other two objectives. If a scope limitation is encountered for a control objective, the auditor should exercise careful judgment in determining if it is appropriate to give an unqualified opinion on management's assertion about the effectiveness of internal controls over any of the objectives. In the case of a scope limitation, the auditor should review the guidance in Statement on Standards for Attestation Engagements Number 2, paragraphs 63 to 65 and consult with the Director of Planning and Reporting to determine the appropriate type of opinion. Section 595 B contains illustrative language for situations (1) where the auditor is satisfied that the scope limitation affects only one control objective and that it is considered appropriate to give an opinion on management's assertion about the effectiveness of controls over the other two objectives, and (2) where the auditor believes a disclaimer report on management's assertion about the effectiveness of internal controls, as a whole, is appropriate due to a scope limitation.

.35 If the auditor has determined that an opinion can be expressed on management's assertion about some or all of the control objectives, the type of opinion to be given depends on whether management's assertion about the effectiveness of internal controls is fairly stated and whether any reportable conditions are identified. Another way to state this is that the type of opinion is based on whether any internal control weaknesses are identified, the significance of such weaknesses, and whether management includes in its assertion a description of the weakness(es) and its (their) effect(s) on achievement of the internal control objectives. In concluding as to the effectiveness of internal controls, for the auditor to compare that conclusion with management's assertion, weaknesses should be categorized, in order of decreasing significance, as (1) material weaknesses, (2) reportable conditions that are not considered to be material weaknesses (other reportable conditions), and (3) other weaknesses less significant than reportable conditions (other weaknesses). Each of these types of weaknesses and its effects on the auditor's conclusion on internal controls is discussed below. If no material weaknesses or other reportable conditions

are identified, the auditor concludes that the internal controls are effective in meeting the control objectives.

Classifying Control Weaknesses

.36 The following definitions and guidelines should be used for classifying internal control weaknesses:

- **A material weakness** is a reportable condition (see below) in which the design or operation of the internal controls does not reduce to a relatively low level the risk that losses, noncompliance, or misstatements in amounts that would be material in relation to the principal statements or to a performance measure or aggregation of related performance measures may occur and not be detected within a timely period by employees in the normal course of their assigned duties.

- **Reportable conditions** include matters coming to the auditor's attention that, in the auditor's judgment, should be communicated because they represent significant deficiencies in the design or operation of internal controls, which could adversely affect the entity's ability to meet the internal control objectives described in the report.

.37 The auditor should consider whether reportable conditions, in combination, result in material weaknesses. If so, the auditor should consider them to be material weaknesses in concluding as to the effectiveness of internal controls and reporting findings, as discussed in paragraphs 580.41-.55. Additional guidance on classification of internal control weaknesses is provided in AU 325.

.38 OMB has provided guidance, supplementing Circulars A-123 (June 21, 1995) and A-127 (July 23, 1993), on materiality for reporting matters under FMFIA. The term "material weakness" as used by OMB in this guidance (FMFIA material weakness) is different from the above definition. 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 reportable condition for reporting as part of management's assertion about the effectiveness of internal controls (see paragraph 580.36).

.39 According to OMB criteria, an internal control weakness is an FMFIA material weakness under A-123 if it is significant enough to be reported

outside the agency, as determined by the agency head (that is, included in the annual Integrity Act report to the President and the Congress).

.40 According to OMB criteria (A-127), nonconformance of entity budget or accounting information and financial systems is material for FMFIA reporting under A-123 if it is material, as judged by the agency head, when weighed against other agency deficiencies.

Effects of Control Weaknesses on the Auditor's Conclusion as to the Effectiveness of Internal Controls

.41 Based on the types of weaknesses noted, the auditor should conclude as to the effectiveness of internal controls as of the end of the audit period, as discussed in paragraphs 580.42-.46. Management concludes as to the effectiveness of internal controls in deciding what assertion to make. As described in paragraph 580.47, the auditor forms an opinion on management's assertion about the effectiveness of internal controls by comparing his or her conclusion with management's assertion.

Material weaknesses

.42 If material weaknesses exist at the end of the audit period, the auditor should conclude that the entity's controls are ineffective or effective "except for" the weakness for the control objective(s) that the weakness affects. The existence of a material weakness precludes a conclusion that the internal control structure is effective for that objective. If a material weakness relates only to one control objective, the auditor should determine whether controls are effective in achieving the other control objectives. The auditor must exercise careful judgment when concluding that the effects of a material weakness are isolated to one control objective.

.43 The auditor must exercise careful judgment in deciding whether it is appropriate in the circumstances to conclude that, "except for" a material weakness, the internal control structure is effective for the objective. Management should exercise careful judgment in deciding what assertion to make about the effectiveness of internal controls. By definition, a material weakness is a very significant condition (see paragraph 580.36) that could allow losses, noncompliance, or misstatements of such a magnitude that the judgment of a reasonable person relying on the information would have been changed or influenced. If, after careful consideration, the auditor determines that, although material, the weakness is not so severe as to judge that the controls for that objective are ineffective, he or she may

conclude that the internal control structure for that objective is effective "except for" the material weakness. However, if the auditor determines that the material weakness(es) is (are) significant enough that he or she cannot judge the internal controls to be effective for that objective, even "except for" the material weakness(es), he or she should conclude that the internal control structure is ineffective for that objective. Factors the auditor should consider in deciding whether an "except for" conclusion is appropriate are:

- whether there is a single material weakness related to the objective, or several;

- whether the material weakness relates to ancillary areas that are low on the list of material items or to a line item or law that is one of the more significant aspects of the agency; and

- whether the material weakness is limited to one or a few assertions that are not generally considered the most significant ones related to the line item, or the assertions are quite significant.

.44 If a material weakness is presented in a report that also includes an unqualified opinion on the principal statements, a statement should be added to the unqualified opinion to indicate that material misstatements may nevertheless occur in other financial information reported by the entity as a result of the material weakness. Illustrative report modifications for material weaknesses are provided in section 595 B.

Reportable conditions other than material weaknesses

.45 If reportable conditions other than those considered to be, individually or in combination, material weaknesses exist at the end of the audit period, the auditor generally may conclude that the controls are effective in achieving the control objectives. However, the auditor's report should be revised (see section 595 B) to highlight that the work performed identified the need to improve certain internal controls.

Weaknesses that do not meet the criteria for reportable conditions

.46 Weaknesses that do not meet the criteria for reportable conditions (paragraph 580.36) do not affect the auditor's conclusion as to the effectiveness of internal controls.

Opinion: Comparison of the Auditor's Conclusion With Management's Assertion About the Effectiveness of Internal Controls

.47 As described in paragraphs 580.33-.35, if the auditor is unable to apply all the audit procedures he or she considers necessary in the circumstances, a scope limitation exists and the report on management's assertion about the effectiveness of internal controls may need to be a qualified opinion or a disclaimer of opinion. If all the procedures considered necessary were performed, the opinion may be one of the following:

- If the auditor and management agree as to the effectiveness of internal controls and there are no material weaknesses or other reportable conditions in internal controls, the opinion on management's assertion about the effectiveness of internal controls is unqualified (see section 595 A).

- If the auditor and management agree as to the effectiveness of internal controls and there are no material weaknesses in internal controls, but there is(are) other reportable condition(s), the auditor modifies the report on management's assertion about the effectiveness of internal controls by stating that internal controls could be improved and by referring to the reportable condition(s) (see section 595 B).

- If the auditor and management agree as to the effectiveness of internal controls and there are material weaknesses in internal controls, the auditor modifies the opinion on management's assertion about the effectiveness of internal controls by (1) referring to the material weakness(es) noted in management's assertion (which states that internal controls with respect to one or more of the internal control objectives--safeguarding, compliance, or financial reporting--are either ineffective or effective "except for" the material weakness) and (2) describing the material weakness(es) (see section 595 B).

- If the auditor and management disagree as to the effectiveness of internal controls, either because (1) management does not agree that material weakness(es) exist or (2) management does not appropriately modify its assertion about the effectiveness of internal controls in light of the material weakness(es), the auditor's opinion is adverse. (The existence of a material weakness precludes management from asserting that its internal control structure is effective for that objective.) Thus, an adverse opinion is appropriate if management states that the internal controls are effective "except for" the material weakness(es),

when, in the auditor's judgment, the material weakness(es) is(are) so severe that the internal controls are ineffective (see paragraph 580.43 and section 595 B).

If the auditor did not obtain a management assertion about the effectiveness of the entity's internal control structure, he or she should not give an opinion on internal controls. If no, or only a few, material weaknesses were found, the auditor should report material weaknesses and other reportable conditions in internal controls, or state that no material weaknesses were found. If, in the auditor's judgment, material weaknesses were so significant that the auditor concludes the internal controls were ineffective for one or more objectives, he or she should state that conclusion in the report. (See section 595 B.)

Where to Report Control Weaknesses

.48 The means of communicating weaknesses in internal controls depends on the type of weakness, as discussed in paragraph 580.36, and whether the weakness was included in management's assertion about the effectiveness of internal controls. Each type of weakness is discussed in paragraphs 580.49-.52 below.

Reportable conditions (including material weaknesses)

.49 If, in the auditor's judgment, a reportable condition is considered to be a significant matter that should be communicated to the entity head, OMB, and the Congress, it should be described in the auditor's report on the annual financial statement. Any material weakness identified by the auditor should be reported in this manner. These matters should be included in the significant matters section of the auditor's report and should be combined with related matters to the extent possible as discussed in paragraph 580.06. If management's assertion about the effectiveness of internal controls is printed in the audit report, the auditor's report should refer to the discussion of the material weakness (or other reportable condition) in management's assertion.

.50 The significant matters section of the auditor's report on the annual financial statement should be limited to summarized information. As such, control weaknesses included in the significant matters section generally should be limited to providing the reader with an understanding of the nature and extent of the weakness. More complete information concerning the weaknesses should be provided in other reports issued prior to or at the

same time as the auditor's report on the annual financial statement. A description of such other reports (such as date and title or report number) should be included in the auditor's report on the annual financial statement.

.51 Reportable conditions not considered to be significant matters individually, as described in paragraph 580.49, should be listed in the significant matters section of the report. Related weaknesses should be combined. Such weaknesses may be reported in more detail in a management letter (or other written communication). The opinion on management's assertion about the effectiveness of internal controls should refer to such letters or communications. To the extent that any such weaknesses contribute to significant matters, they should be described in conjunction with the related significant matter.

.52 The auditor may report weaknesses that do not meet the criteria for reportable conditions in a management letter (including the elements which are reported in the management letter as discussed in paragraph 580.54), orally communicate the weakness to an appropriate level of entity management, or determine that no further consideration is necessary. The auditor should document any oral communication or the basis for the decision not to communicate the weakness.

What To Report About Control Weaknesses

.53 Control weaknesses identified by the auditor are considered to be findings. The GAO General Policies/Procedures Manual, chapter 9, describes the four elements of a finding:

- criteria (what should be),
- condition (what is),
- cause (why the condition occurred), and
- effect (the nature of the possible past or future impact).

.54 Fully developing each of the four elements of a finding is not always necessary. The auditor should use judgment in applying the resources to investigate a control weakness, based on the elements that are to be reported. For each reportable condition, the minimum extent to which the

elements of a finding should be developed depends on how it is communicated.

- **Reportable conditions reported in the auditor's report on the annual financial statement or other report:** The auditor should identify at least the criteria, condition, cause, and possible asserted effect (as to nature, not necessarily amount) to permit federal officials to determine the effect and to take timely and proper corrective action. Each reported finding should include a recommendation.

- **Reportable conditions reported in a management letter (or other approved format):** The auditor should identify at least the condition and the criteria and generally should identify the possible asserted effect. Also, the auditor should provide suggestions for improvements. The auditor should consider the benefits of identifying the cause, which would generally strengthen the suggested improvement.

In discussing each reportable condition that meets FMFIA reporting criteria, the auditor should state whether the reportable condition was identified in the entity's FMFIA report or in the FMFIA report of the organization of which the entity is a part.

.55 For weaknesses that do not meet the criteria for reportable conditions, developing all of the elements of a finding is generally not necessary. The auditor should apply judgment to limit the resources applied to investigate this type of control weakness.

Other Considerations

.56 To communicate audit findings on a timely basis, the auditor should consider issuing reports and/or management letters during the audit. In such instances, the report on the annual financial statement must describe significant matters and the general nature of other reportable conditions (as discussed in paragraphs 580.49-.51) and refer to such reports and/or management letters. The reference should be sufficient to allow the reader to request these reports and/or management letters. For example, titles and dates or accession numbers should be included.

.57 The auditor should consider whether internal control weaknesses, particularly material weaknesses, could affect information in other reports generated by the entity for external distribution or internal decision making. The auditor should make inquiries and consider other knowledge

obtained during the audit concerning use of reports affected by the weaknesses. The auditor should determine, based on his/her judgment whether such reports are significant and likely to contain inaccuracies as a result of such control weaknesses that would likely influence the judgment of the report users. If so, the auditor generally should describe, in the auditor's report, the nature of such reports and the effect of control weaknesses on them. In determining if such reports are significant, the auditor should consider whether user judgments or management decisions based on such reports could affect the entity in amounts that would be material in relation to the principal statements.

COMPLIANCE WITH LAWS AND REGULATIONS

.58 The auditor reports on the results of compliance testing and on compliance matters coming to the auditor's attention during procedures other than compliance tests. The manner in which noncompliance is reported is dependent on the significance of the noncompliance and whether such noncompliance is material to the principal statements, as described below. The auditor should consult with OGC regarding conclusions on the entity's compliance with laws and regulations.

.59 The following definitions and guidelines should be used for classifying noncompliance detected during the audit:

- **Material noncompliance** is reportable noncompliance (see below) in which a failure to comply with laws or regulations results in misstatements that are material to the principal statements. Any instances of material noncompliance must be described in the significant matters section of the auditor's report.

- **Reportable noncompliance** includes all matters coming to the auditor's attention except those that, in the auditor's judgment, are clearly inconsequential.

.60 Reportable noncompliance, other than material noncompliance, should be described in the significant matters section of the auditor's report on the annual financial statement if, in the auditor's judgment, it is considered to be a significant matter that should be communicated to the entity head, OMB, and the Congress. Otherwise, the auditor should list the reportable noncompliance in the significant matters section of the report. Related instances of noncompliance should be combined. Such noncompliance should be reported in detail in another report or in the management letter,

and that other report or management letter should be referred to in the auditor's report on the annual financial statement. To the extent that any such noncompliance contributes to significant matters, it should be described in conjunction with the related significant matter.

.61 Noncompliance that does not meet the criteria for reportable noncompliance may be orally communicated to an appropriate level of entity management, or the auditor may determine that no further consideration is necessary. The auditor should document any oral communication in the workpapers.

Reporting on compliance tests

.62 The auditor states directly whether or not any reportable noncompliance was detected during compliance tests. This type of direct statement is illustrated in section 595 A for a situation in which the compliance tests disclosed no reportable noncompliance. If reportable noncompliance is noted, the statement should be modified as shown in section 595 B, and the reportable noncompliance should be discussed in the significant matters section of the auditor's report according to the guidance in paragraphs 580.60-.61.

Scope of procedures

.63 The auditor should be able to perform all of the procedures considered necessary to obtain sufficient evidence to report on compliance with laws and regulations. If the auditor is unable to perform all of the procedures for each of the significant provisions of laws and regulations, the auditor may be able to report on the laws and regulations tested; however, the auditor should modify the report to alert the reader that not all of the laws that were considered necessary were tested. See section 595 B for report modifications.

.64 If the scope limitation is so significant that the auditor believes that any statement could be misleading, the auditor may omit it. Significant scope limitations should be described in the significant matters section of the auditor's report, and the auditor's report should be modified as described in section 595 B. The auditor should also consider the effect of such a scope limitation on the opinion on the financial statements.

.65 If weaknesses in compliance controls are identified but no instances of noncompliance are found during compliance testing, the auditor should reconsider 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 Director of Planning and Reporting or designee and OGC concerning the appropriate reporting of such weaknesses and compliance tests.

Reporting on management's FMFIA reports

.66 In the compliance section of the auditor's report on the annual financial statement, the auditor considers whether material weaknesses or other reportable conditions identified during the audit were identified in management's FMFIA report. The auditor should investigate any material weaknesses or other reportable conditions discovered during the audit that were not included in the entity's FMFIA report or the FMFIA report of the organization of which the entity is a part. If the auditor found reportable conditions that should have been reported under FMFIA (see paragraphs 580.38-.40), he or she should report them and should determine whether management's FMFIA process has weaknesses that should be reported. Such weaknesses might result from one of the following problems:

- Management did not initially recognize internal control weaknesses, perhaps due to a lack of training or understanding or to limitations on the scope of the FMFIA process. (For example, certain areas were not reviewed annually or certain types of controls were not reviewed.)

- Management did not recognize that identified weaknesses were FMFIA material weaknesses.

- Management relied on controls that the auditor concluded were ineffective.

- Management failed to report identified weaknesses due to inappropriate report preparation (perhaps due to errors in aggregating the internal control weaknesses of branches or agencies).

OTHER INFORMATION IN THE ANNUAL FINANCIAL STATEMENT

.67 As discussed in OMB Bulletin 94-01, certain other information is to be included in the annual financial statement. This information consists of the overview of the reporting entity, combining statements (when considered appropriate by the entity) and other supplemental financial and management information. As this information is required by OMB, the auditor should apply procedures consistent with AU 558 which specifically

addresses supplemental information required by FASB and GASB. As discussed in AU 558, the auditor should compare the consistency of the information with the principal statements and should discuss the methods of measurement and presentation with entity officials.

.68 If there are no material inconsistencies or nonconformance with OMB guidance that come to the auditor's attention during these or other audit procedures, the auditor should state this as shown in section 595 A. If material inconsistencies or instances of nonconformance are noted and are not remedied by the entity, the auditor should describe these situations in the significant matters section of the auditor's report and give a reference to the discussion in the significant matters section as illustrated in section 595 B.

.69 The auditor should also consider whether circumstances that resulted in modification of the auditor's report, such as a scope limitation or departure from established accounting principles, also affect this other information and disclose these effects in the discussion of those circumstances in the significant matters section of the report as described in section 595 B.

.70 Following the objectives, scope, and methodology section of the report, there generally should be a section on agency comments. The auditor should allow the audited entity to review a draft of the report prior to issuance and provide either written or oral comments on it to assure the report is fair, objective, accurate, and complete. 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. Oral comments are preferred when there is a time-critical need to expedite issuance and the auditor has worked closely with the agency so that it is familiar with the findings and issues addressed in the draft, which are not expected to cause disagreements or controversy. If the report is unqualified, the entity may decide not to comment on it. The auditor should briefly characterize the overall response to the draft and summarize the major points made in the comments, whether written or oral, in the final section of the report. If agency officials concurred with all the findings, conclusions, and recommendations, state that they concurred, mention actions the agency has agreed to take, and provide responses the auditor has to those actions. If agency officials disagree with or have concerns regarding portions of the report, discuss these concerns fully and provide the auditor's response to them. Written comments generally should be included as an appendix to the report if they relate to the message,

rather than dealing mostly with technical matters. (See Communications Manual, chapter 12.11.)

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590 - DOCUMENTATION

.01 The auditor should document the nature and extent of work performed in the reporting phase and related conclusions. Such documentation should include:

- evaluation of misstatements,
- inquiries of attorneys,
- subsequent events,
- management representations,
- related party transactions, and
- procedures performed to determine consistency of the other information in the annual financial statement with the principal statements and on conformity with OMB guidelines on form and content of financial statements.

SPECIFIC DOCUMENTATION CONSIDERATIONS

Audit Summary Memorandum

.02 At the completion of the audit, an audit summary memorandum should be prepared which summarizes the audit results and demonstrates the adequacy of the audit procedures and the reasonableness of the conclusions on the principal statements, internal controls, and the entity's compliance with laws and regulations, the overview of the entity and supplemental financial and management information.

.03 The audit summary memorandum generally should refer to other workpapers where this information is described in more detail. The memorandum should briefly summarize and allow the reader to easily refer in the workpapers to

- any significant changes from the auditor's original assessment of the control environment or inherent or control risks and significant revisions of audit procedures;

- significant accounting, auditing, or reporting issues;

- any limitations on the audit scope and the auditor's assessment of whether the audit procedures were adequate to support conclusions on the principal statements, management's assertion about the effectiveness of internal controls, compliance with laws and regulations, the overview, the combining statements and other financial and management information;

- the auditor's conclusions on whether the audit evidence obtained supports the conclusions on the principal statements, management's assertion about the effectiveness of internal controls, compliance with laws and regulations, the overview, and other financial information;

- the auditor's conclusion on whether the audit was done in compliance with GAGAS, OMB Bulletin 93-06 and the GAO Financial Audit Manual and whether the report is appropriate;

- the auditor's conclusion on whether the entity's principal statements comply with the entity's basis of accounting;

- significant subsequent events, if any;

- the Summary of Unadjusted Misstatements;

- a summary of internal control weaknesses and a comparison of those we found to the weaknesses reported in management's assertion about the effectiveness of internal controls;

- a summary of instances of noncompliance with laws and regulations; and

- the documentation of overall analytical procedures.

Overall Analytical Procedures

.04 The following items should be documented in the workpapers for overall analytical procedures:

- **Data used and sources of data:** The documentation on the specific financial data used for the current-year amounts and the data used for comparison should include the amounts of the financial items; the dates or periods covered by the data; whether the data were audited or unaudited; the person from whom the data were obtained, if applicable;

and the source of the information (i.e., SF 220 and SF 221, the general ledger trial balance, prior-year audit workpapers or prior-year financial statements).

- **Parameters for identifying significant fluctuations:** These parameters are left to the auditor's judgement.

- **Explanations for significant fluctuations and sources of these explanations:** Explanations obtained should be consistent with corroborating evidence in the workpapers and should be referenced to this work.

- **Auditor's conclusions on the results of the procedures:** The auditor's conclusions on the results of overall analytical procedures generally should be documented in the reporting phase workpapers.

Considering Weaknesses in Internal Controls

.05 The basis for considering internal control weaknesses as material weaknesses, other reportable conditions, or as not reportable, for purposes of comparing our findings to weaknesses included in management's assertion about the effectiveness of internal controls, should be documented in the workpapers. Any oral communications of control weaknesses that are not included in a written report should be documented in the workpapers. Procedures performed to determine the effects of misstatements and weaknesses in internal controls on other reports prepared and used by the entity also should be documented.

Reporting Instances of Noncompliance

.06 The basis for classification of instances of noncompliance as material noncompliance, other reportable noncompliance or as not reportable should be documented in the workpapers. Any oral communications of noncompliance that are not included in a written report should be documented in the workpapers.

595 A - EXAMPLE AUDITOR'S REPORT - UNQUALIFIED

In our audit of [name of entity] for fiscal [year], we found

- The Principal Statements were reliable in all material respects,
- Management fairly stated that internal controls in place on [date of financial statements] were effective in safeguarding assets from material loss, assuring material compliance with laws governing the use of budget authority and with other relevant laws and regulations, and assuring that there were no material misstatements in the Principal Statements, and
- There was no reportable noncompliance with laws and regulations we tested.

The following sections outline each conclusion in more detail and discuss (1) our conclusions on the Overview of the Reporting Entity and other supplemental information and (2) the scope of our audit.

OPINION ON PRINCIPAL STATEMENTS

The Principal Statements including the accompanying notes present fairly, in all material respects, in conformity with a comprehensive basis of accounting other than generally accepted accounting principles, as described in note X [or with generally accepted accounting principles, if applicable], [name of entity's]

- assets, liabilities, and net position,
- net costs,
- changes in net position,
- budgetary resources,
- reconciliation of net costs to budgetary obligations, and
- custodial activity (if applicable).[1]

[1] This list assumes the entity has adopted recent Statements of Federal Financial Accounting Standards and OMB Bulletin 97-01. If the entity has not adopted this guidance, modify the list to reflect the statements presented.

OPINION ON MANAGEMENT'S ASSERTION ABOUT THE EFFECTIVENESS OF INTERNAL CONTROLS

We evaluated management's assertion about the effectiveness of its internal controls designed to

- safeguard assets against loss from unauthorized acquisition, use, or disposition;
- assure the execution of transactions in accordance with laws governing the use of budget authority and with other laws and regulations that have a direct and material effect on the Principal Statements or that are listed in OMB audit guidance and could have a material effect on the Principal Statements; and
- properly record, process, and summarize transactions to permit the preparation of reliable financial statements and to maintain accountability for assets.

Management of [entity] fairly stated that those controls in place on [end of fiscal year] provided reasonable assurance that losses, noncompliance, or misstatements material in relation to the Principal Statements would be prevented or detected on a timely basis. Management made this assertion based upon criteria established under the Federal Managers' Financial Integrity Act of 1982 and the Office of Management and Budget Circular A-123, Management Accountability and Control [or other control criteria issued under due process procedures used by the agency, such as Internal Control - Integrated Framework, by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission and the Addendum to "Reporting to External Parties," for safeguarding of assets against unauthorized acquisition, use, or disposition; compliance with laws and regulations; and financial reporting controls].

COMPLIANCE WITH LAWS AND REGULATIONS

Our tests for compliance with selected provisions of laws and regulations disclosed no instances of noncompliance that would be reportable under generally accepted government auditing standards or OMB Bulletin 93-06. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

CONSISTENCY OF OTHER INFORMATION

The Overview of the Reporting Entity, the Combining Statements providing financial information by program and activity, and other supplemental information contain a wide range of data, some of which are not directly related to the Principal Statements. We do not express an overall opinion on this information. However, we compared this information for consistency with the Principal Statements and discussed the methods of measurement and presentation with [name of entity] officials. Based on this limited work, we found no material inconsistencies with the Principal Statements or nonconformance with OMB guidance.

OBJECTIVES, SCOPE, AND METHODOLOGY

Management is responsible for

- preparing the annual financial statement in conformity with the basis of accounting described in note X [or generally accepted accounting principles],

- establishing, maintaining, and assessing the internal control structure to provide reasonable assurance that the broad control objectives of FMFIA are met, and

- complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the Principal Statements are reliable (free of material misstatement and presented fairly, in all material respects, in conformity with the basis of accounting described in note X [or generally accepted accounting principles]), and (2) management's assertion about the effectiveness of internal controls is fairly stated, in all material respects, based upon criteria established under the Federal Managers' Financial Integrity Act of 1982 and the Office of Management and Budget Circular A-123, Management Accountability and Control [or other control criteria issued under due process procedures used by the agency, such as Internal Control - Integrated Framework, by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission and the Addendum to "Reporting to External Parties," for safeguarding of assets against unauthorized acquisition, use, or disposition; compliance with laws and regulations; and financial reporting controls]. We are also responsible for testing compliance with selected provisions of laws and regulations and for performing limited

procedures with respect to certain other information appearing in this annual financial statement.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the Principal Statements;

- assessed the accounting principles used and significant estimates made by management;

- evaluated the overall presentation of the Principal Statements;

- obtained an understanding of the internal control structure related to safeguarding assets, compliance with laws and regulations including execution of transactions in accordance with budget authority, financial reporting, and performance measures reported in the overview of the CFO report;

- assessed the design of performance measures controls and whether they had been placed in operation;

- tested relevant internal controls over safeguarding, compliance, and financial reporting and evaluated management's assertion about the effectiveness of internal controls;

- tested compliance with selected provisions of the following laws and regulations [list laws and regulations]; and

- considered compliance with the process required by FMFIA for evaluating and reporting on internal control and accounting systems.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to those controls necessary to achieve the objectives outlined in our opinion on management's assertion about the effectiveness of internal controls. Because of inherent limitations in any internal control structure, losses, noncompliance, or misstatements may nevertheless occur and not be detected. We also caution that projecting our evaluation 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 controls may deteriorate.

We did our work in accordance with generally accepted government auditing standards and OMB Bulletin 93-06, "Audit Requirements for Federal Financial Statements."

AGENCY COMMENTS AND OUR EVALUATION

In commenting on a draft of this report (see appendix x), [entity] concurred with the facts and conclusions in our report.

595 B - SUGGESTED MODIFICATIONS TO AUDITOR'S REPORT

This section suggests how to modify each major section of the unqualified auditor's report on the annual financial statement illustrated in section 595 A for each of the situations listed below.

	Page
Situations relating to the principal statements:	
1. Scope limitation resulting in a qualified opinion on the principal statements	595 B-4
2. Scope limitation resulting in a disclaimer of an opinion on the principal statements	595 B-5
3. Uncertainty resulting in the addition of an explanatory paragraph	595 B-5
4. Uncertainty resulting in a disclaimer of an opinion on the principal statements	595 B-6
5. Lack of consistency in the application of accounting principles resulting in the addition of an explanatory paragraph	595 B-6
6. Departure from established accounting principles resulting in a qualified opinion on the principal statements	595 B-7
7. Departure from established accounting principles resulting in an adverse opinion on the principal statements	595 B-7
Situations relating to internal controls:	
8. Scope limitation resulting in a disclaimer of opinion on management's assertion about the effectiveness of internal controls	595 B-8
9. Scope limitation resulting in a qualified opinion on management's assertion about the effectiveness of internal controls	595 B-9
10. Material weaknesses in internal controls reported in management's assertion about the effectiveness of internal controls	595 B-11
11. Material weaknesses in internal controls not reported in management's assertion about the effectiveness of internal controls	595 B-13

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12. Reportable conditions (other than material weaknesses) in internal controls	595 B-16
13. No management assertion about the effectiveness of internal controls and no material weaknesses or other reportable conditions were found	595 B-19
14. No management assertion about the effectiveness of internal controls and other reportable conditions were found	595 B-21
15. No management assertion about the effectiveness of internal controls and one or a few material weaknesses were found	595 B-23
16. No management assertion about the effectiveness of internal controls and many material weaknesses were found	595 B-25
Situations relating to compliance with laws and regulations:	
17. Scope limitation - some laws and regulations could not be tested	595 B-27
18. Scope limitation - all laws and regulations could not be tested - disclaimer	595 B-28
19. Material noncompliance with laws and regulations	595 B-29
20. Reportable noncompliance (other than material noncompliance) with laws and regulations	595 B-30
21. Material weaknesses or reportable conditions included in the auditor's report on the annual financial statement that were not included in the summary of management's FMFIA reports accompanying the annual financial statement	595 B-31

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Situations relating to the consistency of other information in the annual financial statement (overview, combining statements, and supplemental financial and management information):	
22. Material inconsistency between other information and the principal statements	595 B-32
23. Nonconformance of other information with OMB guidance	595 B-33
24. Any situation that caused the auditor to modify the report on the principal statements, internal controls, or compliance with laws and regulations that also affects other information	595 B-34

Financial Statements				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
1. Scope limitation - qualified opinion (see paragraph 580.14)	First bullet: "Evidence about [identify account(s) affected by the scope limitation] in the Principal Statements was not available because of limitations on the scope of our work. Otherwise, we found the Principal Statements were reliable in all material respects."	Describe significant limitations on the scope of the work.	"Qualified Opinion on Principal Statements: Because of the limitation on the scope of our work described above, we cannot determine if the Principal Statements' presentation of [identify account(s) affected by the scope limitation] is reliable. Otherwise, the Principal Statements, including the accompanying notes, present fairly ..."	Replace last sentence with: "Except for the limitations on the scope of our work on the Principal Statements described above, we did our work in accordance with generally accepted government auditing standards and OMB Bulletin 93-06, 'Audit Requirements for Federal Financial Statements.'"

Financial Statements				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
2. Scope limitation - disclaimer (see paragraph 580.14)	First bullet: "We are unable to give an opinion on the fiscal year 199X Principal Statements of [name of entity] because of limitations on the scope of our work. Thus, the Principal Statements may be unreliable."	Describe scope limitations that caused the disclaimer of the opinion and conclude with the following statement: "Because of this limitation on the scope of our work, we are unable to give an opinion on the Principal Statements."	"Disclaimer of opinion on Principal Statements: As described above, we are unable to give an opinion on the Principal Statements."	Because we did not audit the Principal Statements, delete all references to the auditor's responsibility for auditing the Principal Statements and how that responsibility was fulfilled. (See note 2.)
3. Uncertainty - explanatory paragraph (see paragraph 580.19)	No changes.	No changes. (See note 7.)	Opinion on Principal Statements (see note 7): After the opinion, include an explanatory paragraph describing the uncertainty.	No changes.

Financial Statements				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
4. Uncertainty - disclaimer (see paragraph 580.19)	First bullet: "We cannot give an opinion on the fiscal year 199X Principal Statements of [name of entity] because of uncertainties about [name the area(s) affected by the uncertainties]. Thus, the Principal Statements may be unreliable."	Describe the uncertainty that caused the disclaimer of the opinion at the beginning of this section. Conclude the description of the uncertainty with the following statement: "Because of this uncertainty, we are unable to give an opinion on the Principal Statements."	"Disclaimer of opinion on Principal Statements: As described above, we are unable to give an opinion on the Principal Statements."	No changes. (Unlike the situation where an opinion is disclaimed because of a scope limitation, all the procedures considered necessary were performed.)
5. Lack of consistency in the application of accounting principles - explanatory paragraph (see paragraph 580.20)	No changes.	No changes. (See note 7.)	Opinion on Principal Statements (see note 7): After the opinion, include an explanatory paragraph explaining the accounting change. For example: "As discussed in Note X to the Principal Statements, the entity changed its method of computing depreciation in fiscal year 199X."	No changes.

Financial Statements				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
6. Departure from established accounting principles - qualified opinion (see paragraph 580.21)	First bullet: "The Principal Statements were not reliable in all material respects."	Describe material departures from established accounting principles.	"Qualified opinion on Principal Statements: Except for the departure from established accounting principles described above, the Principal Statements, including the accompanying notes, present fairly ..."	No changes.
7. Departure from established accounting principles - adverse opinion (see paragraph 580.21)	First bullet: "The Principal Statements were unreliable."	Describe material departures from established accounting principles.	"Adverse opinion on Principal Statements: Because of the departure from established accounting principles described above, the Principal Statements, including the accompanying notes, do not present fairly ..."	No changes.

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
8. Scope limitation - disclaimer (see paragraph 580.33)	Second bullet: "We are unable to give an opinion on management's assertion about the effectiveness of internal controls because of limitations on the scope of our work."	Describe limitations on the scope of work that caused the disclaimer of the opinion and conclude with the following statement: "Because of this limitation on the scope of our work, we are unable to give an opinion on management's assertion about the effectiveness of internal controls."	"Disclaimer of Opinion on Management's Assertion About the Effectiveness of Internal Controls: As described above, we are unable to give an opinion on management's assertion about the effectiveness of internal controls."	Because we did not perform adequate procedures to give an opinion on management's assertion about the effectiveness of internal controls, delete all references to the auditor's responsibility for giving such an opinion and how that responsibility was fulfilled. (See note 3.)

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
9. Scope limitation on one objective - qualified opinion (see paragraph 580.33) (continued on next page)	Second bullet: "We are unable to give an opinion on management's assertion about the effectiveness of internal controls over [state objective affected, for example - safeguarding assets from material loss] because of limitations on the scope of our work. Our work on management's assertion about the effectiveness of internal controls over other objectives was not limited, however. We found management fairly stated that controls were effective in [state objectives not affected, for example - (continued on next page)	Describe significant limitations on the scope of the work. This should follow the discussion of a scope restriction on the audit of the Principal Statements, if any, and should conclude with the following statement: "Because of this limitation on the scope of our work, we are unable to give an opinion on management's assertion about the effectiveness of internal controls designed to ... [state the affected control objective, such as safeguard assets against loss from unauthorized acquisition, use, or disposition]."	"Qualified Opinion on Management's Assertion About the Effectiveness of Internal Controls: As described above, we are unable to give an opinion on management's assertion about the effectiveness of internal controls designed to [state control objective affected]. However, we did evaluate management's assertion about the effectiveness of those internal controls designed to [list control objectives not affected by scope limitation]." State the opinion on management's assertion about these objectives: "Management of [entity] fairly stated that those controls in place on [date of fiscal year end] provided reasonable assurance that [list unaffected (continued on next page)	Replace last sentence with: "Except for the limitations on the scope of our work on internal controls described above, we did our work in accordance with generally accepted government auditing standards and OMB Bulletin 93-06, 'Audit Requirements for Federal Financial Statements.'"

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
9. Scope limitation on one objective - qualified opinion (see paragraph 580.33) (continued from previous page)	assuring material compliance with laws governing the use of budget authority and with other relevant laws and regulations and assuring that there were no material misstatements in the Principal Statements.]"		areas, for example - noncompliance or misstatements] material in relation to the Principal Statements would be prevented or detected on a timely basis. Management made this assertion based on... [continue with second sentence after bullets].	

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
10. Material weakness in internal controls relevant to one or more control objective(s) reported in management's assertion about the effectiveness of internal controls (see paragraph 580.42) (continued on next page)	Second bullet: "Management fairly stated that internal controls were ineffective in [state objective(s) affected, for example, safeguarding assets from material loss], but effective in [state objective(s) not affected, for example - assuring material compliance with laws governing the use of budget authority and with other relevant laws and regulations and assuring that there were no material misstatements in the Principal Statements]."	Describe material weaknesses in internal controls and include the term "material weakness" in the description. Indicate whether each weakness was reported by management in FMFIA reports. Add the following to address the possible effects of material weaknesses on other reports: "These deficiencies in internal controls may adversely affect any decision by management which is based, in whole or in part, on information that is inaccurate because of the deficiencies. (continued on next page)	"Opinion on Management's Assertion About the Effectiveness of Internal Controls:" No change to lead sentence and its three bullets. Replace sentence after the bullets with: "Management of [entity] fairly stated that because of the material weakness(es) in internal controls described above, internal controls do not provide reasonable assurance that [state control objective(s) affected, such as unauthorized acquisition, use, or disposition of assets] that could lead to [state effect, such as losses] material in relation to the Principal Statements would be prevented or detected on a timely basis. However, management also fairly stated that controls in place on [date of fiscal year end] provided reasonable assurance (continued)	No changes unless all control objectives are affected by material weakness(es). In that situation, delete the sentences of caution on projection of the evaluation of controls to future periods that begins: "Because of inherent limitations [delete rest of paragraph]..."

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
10. Material weakness in internal controls relevant to one or more control objective(s) reported in management's assertion about the effectiveness of internal controls (see paragraph 580.42) (continued from previous page)		Unaudited financial information reported by [name of entity], including budget information, also may contain misstatements resulting from these deficiencies."	that [state appropriate effect(s) such as, noncompliance or misstatements] material in relation to the Principal Statements would be prevented or detected on a timely basis. Management made this assertion based on ... [continue with second sentence after the bullets]." Opinion on Principal Statements: If the opinion on Principal Statements is unqualified, include the following at the end of the opinion on the Principal Statements: "However, misstatements may nevertheless occur in other financial information reported by [name of entity] as a result of the internal control weakness(es) described above." If the report also includes reportable conditions other than material weaknesses, see note 6.	

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
11. Material weakness in internal controls relevant to one or more control objective(s) not reported in management's assertion about internal controls (see paragraph 580.42) (continued on next page)	Second bullet: "Management's assertion about the effectiveness of internal controls was not fairly stated. Management asserted that internal controls in place at [date] were effective in safeguarding assets from material loss, assuring material compliance with laws governing the use of budget authority and with other relevant laws and regulations, and assuring that there were no material misstatements in the Principal Statements."	Describe material weakness(es) in internal controls and include the term "material weakness" in the description. Indicate whether each weakness was reported by management in FMFIA reports. Add the following to address the possible effects of material weaknesses on other reports: "These deficiencies in internal controls may adversely affect any decision by management which is based, in whole or in part, on information that is inaccurate because of the deficiencies. (continued on next page)	"Adverse Opinion on Management's Assertion About the Effectiveness of Internal Controls:" No change to lead sentence and its three bullets. Replace sentence after the bullets with: "Because of the material weakness(es) in internal controls described above, internal controls do not provide reasonable assurance that [state control objective(s) affected, such as unauthorized acquisition, use, or disposition of assets] that could lead to [state effect, such as losses] material in relation to the Principal Statements would be prevented or detected on a timely basis. In our opinion, because of the effect of the material weakness(es) described above on the achievement of the control objectives, management's assertion that [entity's] internal (continued)	No changes unless all control objectives are affected by material weakness(es). In that situation, delete the sentences of caution on projection of the evaluation of controls to future periods that begins: "Because of inherent limitations [delete rest of paragraph]..."

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
11. Material weakness in internal controls relevant to one or more control objective(s) not reported in management's assertion about internal controls (see paragraph 580.42) (continued from previous page) (continued on next page)		Unaudited financial information reported by [name of entity], including budget information, also may contain misstatements resulting from these deficiencies."	controls provided reasonable assurance that [state effect, such as losses] material to the Principal Statements would be prevented or detected on a timely basis is not fairly stated based on the control criteria used. However, management fairly stated that controls in place on [date of fiscal year end] provided reasonable assurance that [state appropriate effect(s) such as, noncompliance or misstatements] material in relation to the Principal Statements would be prevented or detected on a timely basis. Management made this assertion based on... [continue with the rest of the second sentence after the bullets]." (continued on next page)	

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
11. Material weakness in internal controls relevant to one or more control objective(s) not reported in management's assertion about internal controls (see paragraph 580.42) (continued from previous page)			Opinion on Principal Statements: If the opinion on the Principal Statements is unqualified, include the following at the end of the opinion on the Principal Statements: "However, misstatements may nevertheless occur in other financial information reported by [name of entity] as a result of the internal control weakness(es) described above." If the report also includes reportable conditions other than material weaknesses, see note 6.	

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
12. Reportable conditions (other than material weaknesses) (see paragraph 580.45) (continued on next page)	Second bullet: "Although internal controls should be improved, management fairly stated that internal controls in place on [date] were effective in ... "	For reportable conditions considered to be significant matters that should be communicated to the entity head, OMB, and the Congress (as defined in paragraph 580.49): Describe the weaknesses and indicate (1) that the effects of the weaknesses are not material to the Principal Statements and (2) whether the weaknesses were reported by management in the summary of FMFIA reports. For reportable conditions that are not considered to be significant matters individually (as defined in (continued on next page)	Opinion on Management's Assertion About the Effectiveness of Internal Controls: No change to lead sentence and its three bullets, or the two sentences after the bullets. Following that, continue: "However, our work identified the need to improve certain internal controls, as described above and in [identify other reports or management letters that discuss these internal control weaknesses in more detail by reference to date and GAO document number]. These weaknesses in internal controls, although not considered to be material, represent significant deficiencies in the design or operations of internal controls which could adversely affect the entity's ability to meet the internal control objectives listed (continued on next page)	No changes.

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
12. Reportable conditions (other than material weaknesses) (see paragraph 580.4) (continued on next page) (continued from previous page)		paragraph 580.9): List the weaknesses. Related weaknesses should be combined.	above or meet OMB criteria for reporting matters under FMFIA. If management identified the reportable conditions in its assertion, the sentence after the bullets that begins "However," should instead begin: "Management also fairly stated the need to improve..." Opinion on Principal Statements: If reportable conditions are included as significant matters and the opinion on the Principal Statements is unqualified, include the following at the end of the opinion on the Principal Statements: "However, misstatements may nevertheless occur in other financial information reported by [name of entity] as a result of the (continued on next page)	

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
12. Reportable conditions (other than material weaknesses) (see paragraph 580.4) (continued from previous page)			internal control weakness(es) described above." If the report also includes material weaknesses, see note 6.	

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
13. No management assertion about the effectiveness of internal controls and no material weaknesses or other reportable conditions were found (continued on next page)	Second bullet: "No material weaknesses in the internal control structure and its operation."	No change	"Consideration of Internal Controls: We gained an understanding of internal controls designed to:" No change to three bullets. Replace the paragraph after the bullets with: "We do not express an opinion on internal controls because the purpose of our work was to determine our procedures for auditing the financial statements, not to express an opinion on internal controls. However, for the controls we tested, we found no material weaknesses in the internal control structure and its operations for the period ending on [date]. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or (continued on next page)	See note 8.

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
13. No management assertion about the effectiveness of internal controls and no material weaknesses or other reportable conditions were found (continued from previous page)			irregularities in amounts that would be material to the financial statements may occur and not be detected promptly by employees in the normal course of performing their duties. Our internal control work would not necessarily disclose all material weaknesses."	

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
14. No management assertion about the effectiveness of internal controls and other reportable conditions were found (continued on next page)	Second bullet: "No material weaknesses in the internal control structure and its operation, although internal controls should be improved."	If reportable conditions considered to be significant matters that should be communicated to the entity head, OMB, and the Congress (as defined in paragraph 580.49) were found: Describe the weaknesses and indicate (1) that the effects of the weaknesses are not material to the Principal Statements and (2) whether the weaknesses were reported by management in the summary of FMFIA reports. (continued on next page)	"Consideration of Internal Controls: We gained an understanding of internal controls designed to:" No change to three bullets. Replace the paragraph after the bullets with: "We do not express an opinion on internal controls because the purpose of our work was to determine our procedures for auditing the financial statements, not to express an opinion on internal controls. However, our work identified the need to improve certain internal controls, as described above. These weaknesses in internal controls, although not considered material, represent significant deficiencies in the design or operations of internal controls which could adversely affect the entity's (continued on next page)	See note 8.

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
14. No management assertion about the effectiveness of internal controls and other reportable conditions were found (continued from previous page)		If reportable conditions are not considered to be significant matters individually (as defined in paragraph 580.49): List the weaknesses. Related weaknesses should be combined.	ability to meet the internal control objectives listed above or meet OMB criteria for reporting matters under FMFIA. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to the financial statements may occur and not be detected promptly by employees in the normal course of performing their duties. Our internal control work would not necessarily disclose all material weaknesses."	

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
15. No management assertion about the effectiveness of internal controls and one or a few material weaknesses were found (continued on next page)	Second bullet: "Material weakness(es) over [briefly describe area affected by material weakness(es), for example, reporting expenditures]."	Describe material weaknesses found and include the term "material weakness" in the description. Indicate whether each weakness was reported by management in FMFIA reports. Add the following to address the possible effects of material weaknesses on other reports: "These deficiencies in internal controls may adversely affect any decision by management which is based, in whole or in part, on information that is inaccurate because of the deficiencies. (continued on next page)	"Consideration of Internal Controls: We gained an understanding of internal controls designed to:" No change to three bullets. Replace the paragraph after the bullets with: "We do not express an opinion on internal controls because the purpose of our work was to determine our procedures for auditing the financial statements, not to express an opinion on internal controls. However, we found the material weakness(es) described above. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to the (continued on next page)	See note 8.

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
15. No management assertion about the effectiveness of internal controls and one or a few material weaknesses were found (continued from previous page)		Unaudited financial information reported by [name of entity], including budget information, also may contain misstatements resulting from these deficiencies."	financial statements may occur and not be detected promptly by employees in the normal course of performing their duties. Our internal control work would not necessarily disclose all material weaknesses."	

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
16. No management assertion about the effectiveness of internal controls and many material weaknesses were found (continued on next page)	Second bullet: "Material weaknesses in internal controls which resulted in ineffective controls over [state objectives(s) affected, for example, safeguarding assets from material loss]."	Describe material weaknesses found and include the term "material weakness" in the description. Indicate whether each weakness was reported by management in FMFIA reports. Add the following to address the possible effects of material weaknesses on other reports: "These deficiencies in internal controls may adversely affect any decision by management which is based, in whole or in part, on information that is inaccurate because of the deficiencies. (continued on next page)	"Consideration of Internal Controls: We gained an understanding of internal controls designed to:" No change to three bullets. Replace the paragraph after the bullets with: "We do not express an opinion on internal controls because the purpose of our work was to determine our procedures for auditing the financial statements, not to express an opinion on internal controls. However, we found the material weakness(es) described above, which resulted in ineffective controls over [state objective(s) affected, for example, safeguarding assets from material loss]. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a (continued on next page)	See note 8.

Internal Controls				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
16. No management assertion about the effectiveness of internal controls and many material weaknesses were found (continued from previous page)		Unaudited financial information reported by [name of entity], including budget information, also may contain misstatements resulting from these deficiencies."	relatively low level the risk that errors or irregularities in amounts that would be material to the financial statements may occur and not be detected promptly by employees in the normal course of performing their duties. Our internal control work would not necessarily disclose all material weaknesses."	

Compliance with Laws and Regulations				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope and Methodology
17. Scope limitation - some laws could not be tested (see paragraph 580.63)	Third bullet: "No reportable noncompliance with laws and regulations we tested; however, we could not test compliance with certain laws we considered necessary because of limitations on the scope of our work."	Describe significant scope limitations including a list of the laws not tested.	Compliance with laws and regulations: "Our tests for compliance with the provisions of selected laws and regulations disclosed no instances of noncompliance that would be reportable under generally accepted government auditing standards or OMB Bulletin 93-06; however, as discussed above, we could not test all the laws we considered necessary. The objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion."	Exclude laws not tested from list of laws. Replace last sentence with: "Except for the limitations on the scope of our work on compliance with laws and regulations described above, we did our work in accordance with generally accepted government auditing standards and OMB Bulletin 93-06, 'Audit Requirements for Federal Financial Statements.'"

Compliance with Laws and Regulations				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope and Methodology
18. Scope limitation - all laws could not be tested - disclaimer (see paragraph 580.63)	Third bullet: "We are unable to report on compliance with laws and regulations because of limitations on the scope of our work."	Describe scope limitation. Conclude with: "Because of this limitation on the scope of our work, we are unable to report on compliance with laws and regulations."	Compliance with laws and regulations: Omit statement regarding compliance with laws and regulations. Replace with: "We were unable to test the laws we considered necessary; accordingly, we are unable to report on the entity's compliance with laws and regulations."	Delete all references to the auditor's responsibility for testing compliance with laws and regulations and how that responsibility was fulfilled. (See note 4.)

Compliance with Laws and Regulations				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope and Methodology
19. Material noncompliance with laws and regulations (see paragraph 580.59)	Third bullet: "Reportable noncompliance with laws and regulations we tested."	Describe the material noncompliance and place the findings in proper perspective to give readers a basis for judging the prevalence and consequences of the conditions. Although it is not necessary to use the word "material," a fuller description is necessary than for reportable noncompliance that is not material.	Compliance with laws and regulations: "Except as noted above, our tests for compliance with the provisions of selected laws and regulations disclosed no other instances of noncompliance that would be reportable under generally accepted government auditing standards or OMB Bulletin 93-06. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion."	No changes.

Compliance with Laws and Regulations				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope and Methodology
20. Reportable noncompliance (other than material non-compliance) (see paragraph 580.59)	Third bullet: "Reportable noncompliance with laws and regulations we tested."	For noncompliance that is considered to be a significant matter that should be communicated to the entity head, OMB, and the Congress: Describe the noncompliance. Indicate that the noncompliance is not material to the Principal Statements. For reportable noncompliance that is not considered to be significant: List the noncompliance. Related instances of noncompliance should be combined.	Compliance with laws and regulations: "Except as noted above, our tests for compliance with the provisions of selected laws and regulations disclosed no other instances of noncompliance that would be reportable under generally accepted government auditing standards or OMB Bulletin 93-06. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion."	No changes.

Compliance with Laws and Regulations				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope and Methodology
21. Material weaknesses or reportable conditions not included in the summary of management's FMFIA reports (see paragraph 580.66)	No changes.	Describe the weaknesses in the FMFIA process, or other cause, that resulted in the material conflicts between the summary of management's FMFIA reports and the auditor's evaluation of internal controls.	Compliance with laws and regulations: No change.	No changes.

Consistency of Other Information (Overview, Combining Statements, Supplemental Financial and Management Information)				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusions	Objectives, Scope, and Methodology
22. Material inconsistency between other information and Principal Statements (see paragraph 580.67)	No changes.	Describe material inconsistency.	Consistency of other information: Omit statement that we found no material inconsistencies. Add: "As discussed above, the [list type(s) of other information in the annual financial statement - overview, combining statements, or supplemental financial and management information - that is not consistent with the Principal Statements] is inconsistent with the Principal Statements." If certain type(s) of information are consistent, add: "Otherwise, we found no other material inconsistencies with the Principal Statements and the [state type(s) of information not affected] or nonconformance with OMB guidance."	No changes.

Consistency of Other Information (Overview, Combining Statements, Supplemental Financial and Management Information)				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusions	Objectives, Scope, and Methodology
23. Non-conformance of other information with OMB guidance (see paragraph 580.67)	No changes.	Describe nonconformance with OMB guidance.	Consistency of other information: Omit statement that we found no nonconformance with OMB guidance. Add: "As discussed above, the [list the type(s) of other information in the annual financial statement - overview, combining statements, or supplemental financial and management information - that is not in conformity] does not conform with OMB guidance." If certain type(s) of other information conforms to OMB guidance, add: "Otherwise, we found no other material inconsistencies with the Principal Statements or nonconformance of the [state type(s) of information not affected] with OMB guidance."	No changes.

Consistency of Other Information (Overview, Combining Statements, Supplemental Financial and Management Information)				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusions	Objectives, Scope, and Methodology
24. Any situation that caused the auditor to modify the report on the Principal Statements, internal controls, or compliance with laws and regulations that also affects other information (see paragraph 580.69)	No changes.	In the discussion of the situation, include the effects on the other information in the annual financial statement.	Consistency of other information: Omit statement that we found no inconsistency or nonconformance (or modify to refer only to unaffected type(s) of other information in the annual financial statement - overview, combining statements, or supplemental financial and management information) if considered to be misleading in light of the particular situation. Statement that we found no inconsistencies or nonconformance should be omitted if there is a scope limitation that resulted in a disclaimer of a report on the Principal Statements.	If a scope limitation on the work on the Principal Statements, internal controls, or compliance with laws and regulations results in the omission of the statement that we found no inconsistency of other information, delete all references to the auditor's responsibility for this other information and how we fulfilled that responsibility. (See note 5.)

Note 1: Significant matters

If a significant matters section is included in the auditor's report, add the following statement in quotation marks to the introduction immediately preceding "The following sections outline...":

"Described below are significant matters considered in performing our audit and forming our conclusions."

Note 2: Disclaimer due to a scope limitation on financial statements

In the objectives, scope and methodology section delete the following words in quotation marks:

We are responsible for obtaining reasonable assurance about whether "(1) the Principal Statements are reliable (free of material misstatement and presented fairly, in all material respects, in conformity with the basis of accounting described in note X [or generally accepted accounting principles], and (2)" ...[continue with rest of paragraph].

Delete the following:

" • examined, on a test basis, evidence supporting the amounts and disclosures in the Principal Statements;

• assessed the accounting principles used and significant estimates made by management;

• evaluated the overall presentation of the Principal Statements;"

Add the following words in quotation marks:

"Except for the limitations on the scope of our work on the Principal Statements described above," we did our work in accordance with generally accepted government auditing standards and OMB Bulletin 93-06...[continue with rest of sentence].

Note 3: Disclaimer of opinion on management's assertion about the effectiveness of internal controls due to a scope limitation

In the objectives, scope, and methodology section, delete the following words in quotations marks:

We are responsible for obtaining reasonable assurance about whether "(1)" the Principal Statements are reliable (free of material misstatement and presented fairly, in all material respects, in conformity with the basis of accounting described in note X [or generally accepted accounting principles]", and (2) management's assertion about the effectiveness of internal controls is fairly stated in all material respects based upon criteria established under the Federal Managers' Financial Integrity Act of 1982 and the Office of Management and Budget Circular A-123, Internal Control Systems [or other control criteria issued under due process procedures used by the agency, such as Internal Control - Integrated Framework, by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission and the Addendum to "Reporting to External Parties", for safeguarding of assets against unauthorized acquisition, use, or disposition, compliance with laws and regulations, and financial reporting controls].". ... [continue with rest of paragraph].

Delete the following:

" • obtained an understanding of the internal control structure related to safeguarding assets, compliance with laws and regulations including execution of transactions in accordance with budget authority, financial reporting, and performance measures reported in the overview of the CFO report;

• assessed the design of performance measures controls and whether they had been placed in operation;

- tested relevant internal controls over safeguarding, compliance, and financial reporting and evaluated management's assertion about the effectiveness of internal controls;

- considered compliance with the process required by FMFIA for evaluating and reporting on internal control and accounting systems.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to those controls necessary to achieve the objectives outlined in our opinion on management's assertion about the effectiveness of internal controls. Because of inherent limitations in any internal control structure, losses, noncompliance, or misstatements may nevertheless occur and not be detected. We also caution that projecting our evaluation 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 controls may deteriorate."

Add the following words in quotation marks:

"Except for the limitations on the scope of our work on internal controls described above," we did our work in accordance with generally accepted government auditing standards and OMB Bulletin 93-06...[continue with rest of sentence].

Note 4: Disclaimer of a report on compliance with laws and regulations due to a scope limitation

In the objectives, scope and methodology section, delete the following words in quotation marks:

We are responsible for obtaining reasonable assurance....We are also responsible "for testing compliance with selected provisions of laws and regulations and"... [continue with rest of sentence].

Delete the following:

" • tested compliance with selected provisions of the following laws and regulations [do not list any laws or regulations]; and"

Add the following words in quotation marks:

"Except for the limitations on the scope of our work on compliance with laws and regulations described above," we did our work in accordance with generally accepted government auditing standards and OMB Bulletin 93-06 ... [continue with rest of sentence].

Note 5: Disclaimer of a report on the Principal Statements, internal controls, or compliance with laws and regulations

If scope limitations on our work on the Principal Statements, internal controls, or compliance with laws and regulations result in the omission of the statement that we found no inconsistency of other information, delete the following words in quotation marks from the objectives, scope, and methodology section:

We are responsible for obtaining reasonable assurance....We are also responsible for testing compliance with selected provisions of laws and regulations "and for performing limited procedures with respect to certain other information appearing in the annual financial statement."

Add the following words in quotation marks:

"Except for the limitations on the scope of our work on [state affected area(s)] and on [state type(s) of other information affected] described above," we did our work in accordance with generally accepted government auditing standards and OMB Bulletin 93-06...[continue with rest of sentence].

Note 6: Reporting both material weaknesses and other reportable conditions in the significant matters section

If both material weaknesses and other reportable conditions are included in the significant matters section, the opinion on management's assertion about the effectiveness of internal controls should include the changes for material weaknesses first, and then should continue with an additional paragraph for reportable conditions that begins either "However, [delete "however"] our work [add "also"] identified the need to improve certain internal controls..." or "Management also fairly stated the need to improve...."

Note 7: Explanatory paragraphs

Explanatory paragraphs may be included in either the significant matters section or the opinion section of the report as discussed in paragraph 580.25.

Note 8: No management assertion about the effectiveness of internal controls

In the objectives, scope, and methodology section, delete the following words in quotations marks:

We are responsible for obtaining reasonable assurance about whether "(1)" the Principal Statements are reliable (free of material misstatement and presented fairly, in all material respects, in conformity with the basis of accounting described in note X [or generally accepted accounting principles])", and (2) management's assertion about the effectiveness of internal controls is fairly stated in all material respects based upon criteria established under the Federal Managers' Financial Integrity Act of 1982 and the Office of Management and Budget Circular A-123, Management Accountability and Control [or other control criteria issued under due process procedures used by the agency, such as Internal Control - Integrated Framework, by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission and the Addendum to "Reporting to External Parties," for safeguarding of assets against unauthorized acquisition, use, or disposition; compliance with laws and regulations; and financial reporting controls]".

Revise the last sentence of the paragraph to read:

"We are also responsible for obtaining a sufficient understanding of internal controls to plan the audit, for testing compliance with selected provisions of laws and regulations, and for performing limited procedures with respect to certain other information appearing in this annual financial statement."

Delete the following words in quotation marks:

- assessed the design of "performance measures" controls and whether they had been placed in operation;
- tested relevant internal controls over safeguarding, compliance, and financial reporting "and evaluated management's assertion about the effectiveness of internal controls";

Revise the second sentence of the paragraph that begins, "We did not evaluate all..." to read:

"We limited our internal control testing to those controls necessary to achieve the objectives outlined in our statement on internal controls."

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595 C - SUMMARY OF POSSIBLE ADJUSTMENTS

Summary of Possible Adjustments
(In Thousands)

From W/P	Description	Known Misstatements		Likely Misstatements		Corrected by Entity? [1]	W/P Ref [2]
		Debit	Credit	Debit	Credit		
XX	*Contractual Services* *Accounts Payable* *Services received, not recorded.*	*$ 2,000*	*$ 2,000*	*$ 4,000*	*$ 4,000*	*Known - No* *Likely - No*	
XX	*Inventory* *Accounts Payable* *Inventory received, not recorded.*	*4,000*	*4,000*	*7,000*	*7,000*	*Known - Yes* *Likely - No*	
	Total	*$ 6,000*	*$ 6,000*	*$11,000*	*$11,000*		

Conclude (in consultation with the Director of Planning and Reporting or designee as discussed in 540.04) as to the adequacy of the scope of procedures performed in light of the total likely misstatements above.

[1] Post any uncorrected known or likely misstatements to the Summary of Unadjusted Misstatements for further consideration.

[2] Reference should be to the adjustments posted on the trial balance or to the Summary of Unadjusted Misstatements if the entity declines to record an adjustment to the principal statements.

595 D - SUMMARY OF UNADJUSTED MISSTATEMENTS

.01 The Summary of Unadjusted Misstatements, as discussed in paragraph 540.09, is used to accumulate known and likely misstatements that are identified by the auditor but not corrected by the entity in the principal statements. The source of these unadjusted misstatements is the Summary of Possible Adjustments (section 595 C).

(Amounts in thousands)	Adjustment Number	Known Misstatements Debit	Known Misstatements (Credit)	Known Misstatements Net Debit (Credit)	Likely Misstatements Debit	Likely Misstatements (Credit)	Likely Misstatements Net Debit (Credit)	Adjusted Account Balance Workpaper Reference	Adjusted Account Balance Debit (Credit)	Likely Misstatement as a % of Account Balance Overstatement (Understatement)
Assets:										
Cash	1	100		100	100		100	[The auditor	12,000	-0.83%
Investments								would	80,000	0.00%
Loans receivable	2		(1,400)	(1,400)		(1,400)	(1,400)	reference	120,000	1.17%
Interest receivable	3	120		120	220		220	the adjusted	60,000	-0.37%
								account		
Total assets		220	(1,400)	(1,180)	320	(1,400)	(1,080)	balances to	272,000	0.40%
								the		
Liabilities:								appropriate		
Accounts payable	4		(150)	(150)		(350)	(350)	working	(175,000)	-0.20%
Other liabilities	5		(40)	(90)		(100)	(300)	paper (for	(85,000)	-0.35%
	6		(50)			(200)		example, the		
								final trial		
Total liabilities		0	(240)	(240)	0	(650)	(650)	balance)].	(260,000)	-0.25%
Equity of U.S. Gov't:										
Beginning of year									(2,000)	0.00%
Net current year (surplus) deficit		1,640	(220)	1,420	2,050	(320)	1,730		(10,000)	17.30%
Total equity		1,640	(220)	1,420	2,050	(320)	1,730		(12,000)	14.42%
Total liabilities and equity		1,640	(460)	1,180	2,050	(970)	1,080		(272,000)	0.40%

(Amounts in thousands)	Adjustment Number	Known Misstatements Debit	Known Misstatements (Credit)	Known Misstatements Net Debit (Credit)	Likely Misstatements Debit	Likely Misstatements (Credit)	Likely Misstatements Net Debit (Credit)	Adjusted Account Balance Workpaper Reference	Adjusted Account Balance Debit (Credit)	Likely Misstatement as a % of Account Balance Overstatement (Understatement)
Operating revenues	1		(100)	(220)		(100)	(320)		250,000	-0.13%
	3		(120)			(220)		[The auditor would reference the adjusted account balances to the appropriate working paper (for example, the final trial balance)].		
Other financing sources									500,000	0.00%
Total revenues and other financing sources		0	(220)	(220)		(320)	(320)		750,000	-0.04%
Operating expenses:										
Personnel	4	150		150	350		350		425,000	-0.08%
Supplies	5	40		40	100		100		115,000	-0.09%
Rent, communication, and utilities	6	50		50	200		200			
Provision for losses	2	1,400		1,400	1,400		1,400		125,000	-0.16%
									75,000	-1.87%
Total operating expenses		1,640	0	1,640	2,050	0	2,050			
									740,000	-0.28%
Net results - (surplus) deficit		1,640	(220)	1,420	2,050	(320)	1,730			
									(10,000)	17.30%

Conclusion: The identified, unadjusted misstatements listed above do not appear to materially misstate the principal statements taken as a whole from a quantitative or qualitative viewpoint. Unadjusted likely misstatements have a $2.05 million effect on operating expenses, the key number for users of these financial statements. The allowance for the imprecision of audit procedures is estimated at $5 million. This total ($7.05 million) is less than 1% of total operating expenses of $740 million and is not material.

APPENDIXES

Appendix A

CONSULTATION WITH THE DIRECTOR OF PLANNING AND REPORTING OR DESIGNEE

.01 The paragraphs listed below refer to situations when the auditor should consult with the Director of Planning and Reporting - AIMD or designee:

100.23	Departing from a policy or procedure designated as "should" in the manual.
230.07	Using an amount for planning materiality that does not follow the guidelines in the manual.
260.05	Using an overall assurance level other than 95%.
285.04, 295 C	Using a plan other than that described in the section 295 C for selecting locations to visit.
290.04	Concluding on the likelihood of effective EDP-related controls on a preliminary basis.
395 G.07	Planned rotation of EDP-related control testing.
480.35	Determining the adequacy of substantive procedures in light of any misstatements identified and/or reassessment of combined risk.
480.37	Determining the adequacy of procedures performed when significant misstatements are detected using DUS and when projected misstatements approach or exceed design materiality.
530.01	Determining the need to perform additional procedures when there are questions about the adequacy of work performed.
540.04	Reviewing the Summary of Possible Adjustments.
540.08	Considering the performance of additional procedures to increase assurance in projected misstatements.
540.12	Considering the materiality of unadjusted misstatements and their effects on the financial statements.

540.16	Determining the effects on the auditor's report, if any, of material misstatements detected in the current year that arose during prior periods but were not detected during prior audits.
580.34	Determining the appropriate form of opinion on management's assertion about the effectiveness of internal controls when there is a scope limitation.
580.65	Determining the effects on the auditor's report if weaknesses are found in compliance controls, but no instances of noncompliance are detected.
450.17 450.18 480.08 480.22 480.29 480.33 480.36 480.39 480.40	Consulting with sampling specialist for assistance in sampling.
650.20, 650 B-7, step 7	Documenting other government auditors' independence and objectivity.
650.47, 650.48	Having concerns about whether other auditors' work provides sufficient evidence.
650 B-8, step 10	Obtaining overview of government audit organization's policies and procedures if it has not had a recent peer review or inspection.

Appendix B

INSTANCES WHERE THE AUDITOR "MUST" COMPLY WITH THE FAM

.01 In the paragraphs listed below the word "must" is used to indicate a situation in which the auditor is required to comply with the FAM:

Preface	(Last paragraph on page 1.) The auditor must follow the FAM unless the Director of Planning and Reporting, AIMD, approves an exception.
100.15	The audit must be designed to achieve the objectives of OMB Bulletin 93-06.
100.23	Definition of "must."
260.04	The audit must be designed to achieve 95 percent audit assurance that the financial statements are not materially misstated.
260.26	The auditor must exercise his or her own judgment in using work done for FMFIA.
270.01	The understanding of internal controls must include EDP aspects.
295 C.07	The auditor must apply analytical or other substantive procedures to locations not tested in using nonrepresentative sample selection, unless immaterial.
310.05	The auditor must evaluate and test various types of controls.
370.11	The auditor must conclude on budget controls and report weaknesses found.
370.13	The auditor must conclude on compliance controls and report weaknesses found.
395 G.02	In using rotation testing of controls, the auditor must perform limited tests annually in areas not selected for testing.

420.04 The auditor must determine, based on judgment, the extent of tests to perform.

450.12 The auditor must follow the guidance in this paragraph in revising the preliminary assessment of control effectiveness if errors exceed amounts in tables 1 and/or 2. (Three "musts" in paragraph.)

470.05 In order to rely completely on an analytical procedure, it must be so persuasive that it will detect misstatements that exceed test materiality.

475.07 In order to rely on a substantive analytical procedure, a difference that exceeds the limit must be explained. (Two "musts" in paragraph.)

475.12 In performing a substantive analytical procedure, if the explanation is not adequate to explain the difference, the auditor must do additional substantive testing.

475.13 Additional procedures must provide adequate assurance that misstatements that exceed test materiality are identified.

475.15 The auditor must obtain an overall understanding of current year financial statements in using overall analytical procedures at the financial statement level.

480.06 In representative sampling, each item in the population must have the opportunity to be selected.

480.07 In testing items with a certain characteristic, other procedures must be applied to other items in the population if material.

480.09 In representative sampling, sample items must be selected from all items so that each item has an opportunity to be selected.

480.34 The auditor must project representative sample results to the population or perform other procedures to determine if a misstatement should be judged to be isolated. (Two "musts" in paragraph.)

480.41 The auditor must evaluate the quantitative and qualitative effects of known and projected misstatements in relation to financial statements as a whole.

490.03 The auditor must consider the implications of misstatements detected in applying supplemental analytical procedures.

495 A.11 In using analytical procedures, if an account is compared with another current year amount, that amount must be audited other than by an analytical procedure using its relationship to this account.

495 A.12 In analytical procedures, the auditor must document why a prior year amount has a plausible and predictable relationship with the current year amount, and adjustments must be supported by reliable data and corroborated. (Four "musts" in paragraph.)

495 A.21 In using computer-produced data in performing analytical procedures, the auditor must either test the EDP controls in the system, or test the reliability of the data produced. (Two "musts" in paragraph.)

495 C.04 The auditor must perform additional procedures to extend the results of interim testing to year end.

510.01 The auditor must conclude on the financial statements, internal control, compliance, and other information included.

520.01 The auditor must perform overall analytical procedures.

520.07 (First bullet.) In overall analytical procedures, the auditor must use audited, adjusted current year amounts.

540.07 The auditor must bring all misstatements found to management's attention.

540.09 The auditor must consider the effect of unadjusted misstatements.

550.08 If management does not give the auditor a management representation letter, the auditor must consider it a scope

limitation and modify the audit report. (Two "musts" in paragraph.)

570.01 The auditor must determine whether the audit was conducted in accordance with GAGAS, OMB Bulletin 93-06, and the FAM, and document the conclusion on compliance in the workpapers. (Two "musts" in paragraph.)

580.11 In reporting, the auditor must consider scope, uncertainties, consistency, and departures from accounting principles.

580.12 The auditor must consider the above four areas and the results of audit procedures in determining the opinion.

580.14 The auditor must determine if the audit was conducted in accordance with GAGAS and OMB Bulletin 93-06 to opine.

580.21 If the scope was adequate, the auditor must determine the appropriate opinion.

580.33 In order to express an opinion on management's assertions about the effectiveness of the internal control structure, the auditor must be able to perform all the procedures considered necessary.

580.42 The auditor must exercise careful judgment in concluding whether the effects of a material weakness are limited to a single objective.

580.43 The auditor must exercise careful judgment in deciding whether management's "except for" assertion about the effectiveness of the internal control structure is appropriate.

580.56 Report on the financial statements must describe significant matters found, even if other reports are issued.

580.59 Material noncompliance must be described in the significant matters section.

GLOSSARY

GLOSSARY

Accounting applications

The procedures and records used to identify, record, process, summarize, and report a class of transactions. 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 and equipment.

Accounting system

The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.

Analytical procedures

The comparison of recorded account balances with expectations or estimates developed by the auditor, based on an analysis and understanding of the relationships between the recorded amounts and other data, to form a conclusion on the recorded amount. A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to continue unless there are known conditions that would change the relationships.

Annual financial statement

As defined by OMB, the annual financial statement comprises

- an overview of the reporting entity
- the principal statements
- the notes to principal statements
- the combining statements, and
- supplemental financial and management information.

Appropriation The most common form of budget authority; an authorization by an act of the Congress that permits federal agencies to incur obligations and to make payments out of the Treasury for specified purposes. Appropriations do not represent cash actually set aside in the Treasury for purposes specified in the appropriation acts. They represent limitations of amounts that agencies may obligate during the period specified in the appropriation acts.

Assertions Management's representations that are embodied in the account balance, transaction class, and disclosure components of the financial statements. The primary assertions (described in paragraph 235.02) are

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure.

Assessing control risk The process of evaluating the effectiveness of an entity's internal controls in preventing or detecting misstatements in financial statement assertions.

Audit risk The risk that the auditor may unknowingly fail to appropriately modify his/her opinion on financial statements that are materially misstated.

Back door authority Any type of budget authority that is provided by legislation outside the normal appropriations process. (See contract authority.)

Base data Data used to develop the expectation in an analytical procedure.

Borrowing authority Statutory authority that permits obligations to be incurred but requires that funds be borrowed to liquidate the obligations (title 7). Usually, the amount that may be borrowed and the purposes for which the borrowed funds must be used are stipulated by the authorizing statute. Borrowing authority sometimes is referred to as back door authority.

Budget authority Authority provided by law (1) to enter into obligations that will result in immediate or future outlays involving government funds or (2) to collect offsetting receipts (2 U.S.C. 622(2)). The Congress provides an entity with budget authority and may place restrictions on the amount, purpose, and timing of the obligation or expenditure of such authority. The three forms of budget authority are

- appropriations,
- borrowing authority, and
- contract authority

Budget controls Management's policies and procedures to manage and control the use of appropriated funds and other forms of budget authority.

Closed account A budget account for which the expired budget authority has been cancelled.

Combined risk Combined inherent and control risk (high, moderate, or low); the risk that the financial statements contain material misstatements before audit.

Compliance controls Policies and procedures management uses to comply with laws and regulations.

Compliance tests Tests to obtain evidence on the entity's compliance with significant laws and regulations.

Contract authority Statutory authority that permits obligations to be incurred before appropriations or in anticipation of receipts to be credited to a revolving fund or other account (offsetting collections). By definition, contract authority is unfunded and must subsequently be funded by an appropriation to liquidate the obligations incurred under the contract authority or by the collection and use of receipts.

Control environment The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include (1) management's philosophy and operating style, (2) organizational structure, (3) methods of assigning authority and responsibility, (4) management control methods, (5) effectiveness of IG and internal audit function, (6) personnel policies and practices, (7) external influences on the entity, (8) control methods over budget formulation and execution, (9) control methods over compliance with laws and regulations, (10) ability to identify and react to changing conditions, and (11) functioning of oversight bodies.

Control risk The risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal controls (classified as high, moderate, or low).

Control techniques (procedures) The policies and procedures, in addition to the control environment and accounting system, that management has established to provide reasonable assurance that specific entity objectives will be achieved.

Control tests Tests of a specific control technique to assess its effectiveness in achieving control objectives.

Design materiality The portion of planning materiality that has been allocated to line items or accounts. This amount will be the same for all line items or accounts (except for certain offsetting balances as discussed in paragraph 230.10). Design materiality for the audit should be established as one-third of planning materiality.

Detection risk The risk that audit procedures will not detect a material misstatement that exists in the financial statements.

EDP audit specialist A person with specialized technical knowledge and skills who can understand the EDP concepts discussed in the manual and apply them to the audit.

EDP-related controls Controls whose effectiveness depends on computer processing, including general, application, and user controls (described in section 295 F).

Errors Unintentional misstatements or omissions of amounts or disclosures in financial statements.

Expectation The auditor's estimate of an account balance in an analytical procedure.

Expired account A budgetary account in which the balances are no longer available for incurring new obligations because the time available for incurring such obligations has expired. After 5 years, these accounts are cancelled and are then considered to be closed accounts.

Financial reporting controls The policies and procedures that pertain to the entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the financial statements.

Financial statements The principal financial statements and the notes to those statements. The notes are considered to be an integral part of the principal statements and are necessary for complete financial presentation.

Inherent risk The susceptibility of an assertion to a material misstatement, assuming there are no related specific control techniques.

Internal controls The policies and procedures established to provide reasonable assurance that the entity's specific objectives are achieved. Following are the types of internal controls:

- financial reporting,
- budget,
- compliance, and
- operations.

Irregularities Intentional misstatements or omissions of amounts or disclosures in financial statements.

Known misstatement The amount of misstatement found by the auditor.

Likely misstatement The auditor's best estimate of the amount of the misstatement (including known misstatement). For sampling applications, this amount is the projected misstatement.

Limit Used in performing substantive analytical procedures, the limit is the amount of difference between the expectation and the recorded amount that the auditor will accept without investigation. Therefore, the auditor should investigate amounts that exceed the limit during analytical procedures.

Materiality 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 planning materiality, design materiality, and test materiality.

Multi-purpose testing Performing numerous tests, such as control tests, compliance tests, and substantive tests, on a common sample.

Obligation ceiling A limit set by the Congress on the amount of obligations and expenditures the entity may incur even though the budget authority (such as an appropriation) is greater than this limit.

Offsetting collections Collections of a business- or market-oriented nature and intragovernmental transactions. If, pursuant to law, they are deposited to receipts accounts and are available for obligation, they are considered budget authority and referred to as offsetting receipts. Contract authority and immediate availability of offsetting receipts for use are the usual forms of budget authority for revolving funds.

Operations controls Management's policies and procedures to carry out planning, productivity, programmatic, quality, economy, efficiency, and effectiveness objectives.

Overall analytical procedures Analytical procedures performed as an overall financial statement review during the audit reporting phase.

Performance measures controls Policies and procedures management uses to assure data that support performance measures reported in the overview of the CFO report are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Planning materiality The auditor's estimate of the aggregate misstatements that would be material in relation to the financial statements to be audited; used for planning the audit scope.

Population The items comprising a financial statement line item, account balance, or class of transactions from which selections are made for audit testing.

Preliminary analytical procedures Analytical procedures performed during the audit planning phase.

Principal (financial) statements The components of a federal entity's annual financial statement, which include the

- Statement of overall financial position,
- Statement of operations,
- Statement of cash flows (or changes in financial position),[1] and
- Statement of budgetary resources and actual expenses.[1]

Projected misstatement An estimate of the misstatement in a population, based on the misstatements found in the examined sample items; represents misstatements that are probable. The projected misstatement **includes** the known misstatement.

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[1] The Government Management Reform Act eliminates the requirement for the cash flow and budgetary resources and actual expenses statements as of fiscal year 1996. OMB, per memo of November 18, 1994, will waive the requirement for these two statements upon request from agencies.

Recorded amount The financial statement amount being tested by the auditor in the specific application of substantive tests.

Representative sampling The application of audit procedures to fewer than all items comprising a population to reach a conclusion about the entire population. The auditor selects sample items in such a way that the sample and its results are expected to be representative of the population. Each item must have an opportunity to be selected, and the results of the procedures performed must be projected to the entire population.

Safeguarding controls Internal controls to protect assets from loss arising from misstatements in processing transactions and handling the related assets. In this manual, safeguarding controls are considered part of financial reporting controls.

Sampling interval The amount between two consecutive sample items, used in selecting the items in systematic sampling. In dollar-unit sampling, this amount is determined by dividing the test materiality by a statistical risk factor.

Sampling risk The risk that the auditor's conclusion based on a sample might differ from the conclusion that would be reached by applying the test in the same way to the entire population.

Specific control evaluation (SCE) Evaluating the effectiveness of the design and operation of specific control techniques. This process is documented on the SCE worksheet.

Stratification Separation of a population into relatively homogeneous groups, each of which is referred to as a stratum, usually to improve sampling efficiency.

Substantive analytical procedures Analytical procedures used as substantive tests.

Substantive tests Specific tests to detect material misstatements in the account balance, transaction class, and disclosure components of financial statements.

Supplemental analytical procedures 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.

Test materiality An amount used in determining the extent of a specific substantive test. The amount represents design materiality, judgmentally reduced when

- the audit is being performed at some, but not all, entity locations (requiring increased audit assurance for those locations visited);
- the area tested is deemed to be sensitive to the financial statements users; or
- the auditor expects to find significant misstatements.

Tolerable rate In attribute sampling, the maximum rate of deviation from a prescribed control that the auditor would be willing to accept without altering the assessment of the effectiveness of the control.

Top stratum item An item in a dollar-unit sample that equals or exceeds the amount of the sampling interval or implicit sampling interval.

Walkthroughs Audit procedures to confirm the auditor's understanding of the actual operation of significant aspects of accounting system processing and control techniques. Walkthroughs of financial reporting controls consist of tracing one or more transactions from initiation through all processing to inclusion in the general ledger, and observing the processing and applicable controls in operation, making inquiries of personnel applying the controls, and examining related documents.

ABBREVIATIONS

ABBREVIATIONS

AIMD	Accounting and Information Management Division
ARA	Account Risk Analysis
AT	Reference to Statements on Standards for Attestation Engagements in the sections of the Codification of Statements on Auditing Standards
AU	Reference to Statements on Auditing Standards in the sections of the Codification of Statements on Auditing Standards
CFO	Chief Financial Officers
DUS	Dollar-unit sampling
EDP	Electronic Data Processing
FASAB	Federal Accounting Standards Advisory Board
FASB	Financial Accounting Standards Board
FMFIA	Federal Managers' Financial Integrity Act
GAAS	Generally accepted auditing standards
GAGAS	Generally accepted government auditing standards
GAO	General Accounting Office
GRA	General Risk Analysis
IG	Inspector General
OGC	Office of General Counsel/AIMD
OMB	Office of Management and Budget
OSI	Office of Special Investigations
SAS	Statement on Auditing Standards

SCE	Specific Control Evaluation
SFFAS	Statement of Federal Financial Accounting Standards
SSAE	Statement on Standards for Attestation Engagements

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